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RECENT BANKING DEVELOPMENTS

Lessons of the Depression and the War



SAROJ KUMAR BASU M.A., Ph.D.

University Lecturer in Economics, Calcutta,

*Author of Industrial Finance in India, Industrial Credit in War
and Post-war Economy, Settlement of Sterling Balances, etc.*

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PREFACE TO THE FIRST EDITION

THE years 1929 and 1939 constitute important landmarks in the history of the world's banking development. In 1939 the structure of central as well as commercial banking came to be profoundly affected by a world war such as history had never known; in 1929 their very foundations had been shaken by an upheaval hardly less convulsive than a world war. The pattern of banking developments in the post-depression and the recent war-period has been so strikingly significant—both theory and practice tending to drift away from their traditional moorings—that it is well worth while to recall a few of its high lights. In the following pages an attempt has been made to analyse and interpret the main-trends in central and commercial banking in the various countries of the world during the post-depression and the war-period. Against this wider international background, the Indian banking situation has been particularly studied as a piece in the whole mosaic. The period under review is packed with such far reaching banking developments ; it has such a wealth and variety of banking experience ; and the problems and the attempts at their solution have been so varied that it will be profitable to consider carefully the lessons afforded by them. The various features have been sought to be thrown into bold relief by contrasting them with banking trends in the period between World War I and the onset of the depression. Finally, an attempt has been made to review the banking problems in the immediate post-war period and indicate the lines along which their solution may be reached. The materials for the work have been gathered from official and authoritative sources as far as possible. I have principally

depended upon Bank Publications, Government Reports and Studies of the League of Nations. A field enquiry through the circulation of a detailed questionnaire has also been conducted with bankers and government departments. In this connection I must express my grateful thanks to Sir C. D. Deshmukh, Governor of the Reserve Bank of India, for making some useful suggestions. But I have been greatly hampered in my study of Indian banking by the general reluctance of the authorities to furnish the necessary information and the entire non-existence of relevant statistics, while such information and statistics are readily available for other countries. In the circumstances the comparative study which I have undertaken has inevitably suffered from some limitations in its Indian sector. In some cases I have been at great pains to obtain the necessary data. In some important respects, relevant banking statistics are poor or entirely non-existent. A few instances may be mentioned here. Statistics relating to the "Average Note" in circulation, a concept which is being recently used with profit to illustrate the international trend in the composition of note circulation, and the percentage of note circulation to the national income are not readily available for our country. I have attempted to calculate the "Average Note" from the available data. But official figures for the national income do not exist and hence the relationship which the note circulation bears to it can not be examined. Again figures relating to the proportion of government debt absorbed by the banking system and even its distribution between the central and commercial banks and those relating to liquid asset holdings of business and individuals are available for a number of countries abroad but the relevant statistics are not obtainable for India. Instances need not be multiplied. The Reserve Bank of India has a

department of statistics but the statistical material published by it is not only meagre but also several years on arrears. It is scarcely necessary to point out that there is plenty of scope for improvement in this direction.

THE UNIVERSITY.
Calcutta, 27 April 1946. }

SAROJ KUMAR BASU.

PREFACE TO THE SECOND EDITION

THE second edition of the book was undertaken at a time when the whole country was in the grip of the worst civil disturbances ever known in its history. Apart from the enormous difficulties of obtaining paper and printing facilities, any serious intellectual work became frequently impossible. The publication of the second edition has thus been inevitably delayed. But it is a great thing that the edition is seeing the light of day in independent India.

The book has been thoroughly revised and brought up-to-date as far as a work of this type can be so brought. A large amount of additional material has been incorporated. Among the new features of the present edition, the following may be mentioned in particular. The recent debacle in the Indian stock market and the part played by a number of Indian banks in that connection has been closely examined and the question of fixing margin requirements as a regulatory instrument on American lines has been carefully considered. The amendments proposed by the Select Committee in their Report dated 17th February, 1947 to the

Indian Banking Companies Bill, 1946 have also been discussed at length. Finally, the entire Part Four is new. The position of national central banks *vis-a-vis* the International Monetary Fund, the potentialities of the International Bank for Reconstruction and Development and the bearing upon India's monetary system of the obligations which her membership of the I. M. F. entails have been studied in this Part. A discussion of these complex issues has been called for by the recent starting of operations by the Fund and the Bank.

INDEPENDENCE DAY
The University, Calcutta

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SAROJ KUMAR BASU.

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PART ONE

**CENTRAL BANKS THROUGH DEPRESSION
AND IN WAR-TIME**

CHAPTER I

INTRODUCTORY

It would be misleading to suggest that Central Banking to-day has reached a settled and final status. As a recent writer has well observed, it is in most of its branches a relatively new art and is still in a process of development and extension.¹ Throughout the nineteenth century down to the outbreak of the First World War in 1914, the principles of central banking had been slowly but steadily evolving themselves. In the period intervening between that War and the Great Depression, most of these principles carefully built up during the past years came to be gradually modified in practice and even deliberately discarded. The "plea" put forward was the stress of emergent conditions.² It is in the post-depression period, however, that by far the most remarkable departures were made from the position as understood in the pre-war or even the immediate post-war period. The theory and practice of central banking showed a most unmistakable trend to drift away from the traditional moorings. The evolution of central banking was still far from complete. The Second World War brought about hardly less striking changes. At the present moment it is not at all possible to predict what the ultimate phase of central banking would be. Central banking is still in a state of formation and flux. Ideas regarding its proper functions have differed widely from time to time and even from place to place. Its methods

¹ A. F. W. Plumptre, *Central Banking in the British Dominions*, p. 14.

² Parker Willis, *Theory and Practice of Central Banking with special reference to the Federal Reserve System*, p. 56.

have varied according as it has operated in one type of money market or another,—in a broad and well-organised money market like that of London or New York ; in subsidiary money markets like those of Berlin, Paris and Amsterdam ; or finally in narrow or ill-organised markets like those of the Argentine, India and the Dominions. Its organization, instruments and objectives have been shaped from time to time by upheavals in the political or economic world, such as revolutions, war and peace, booms and depressions. Its development has been influenced to no small extent by human elements in the shape of its executive personnel. At one time central banking was identified with Bank of England banking ; and the Bank of England was copied in the statutes of central banks elsewhere down to its minutest rules and practices, regardless of the peculiar conditions of their money markets and oblivious of the fact that some of these rules and laws themselves had become, as Mr. Butlin has aptly remarked, “ irrelevant anachronisms ” even in England.¹ The Bank of England itself in 1944, to quote Sir John Clapham, was further from 1944 than 1944 was from 1844 and in some important ways further from 1944 than 1944 was from 1714.² It is being increasingly recognised to-day that Central Banking is not necessarily identical with Bank of England banking. There is no universal technique of central banking but a special problem in every clime and perhaps for every time.

The pattern of central banking development in the post-depression and the recent war period has been so strikingly significant that it is well worth while to recall a

¹ In reviewing Mr. Plumptre's book in the *Economic Record*, December 1940, p. 286.

² Sir John Clapham, *The Bank of England. A History*, Vol. II, p. 417.

few of its high lights. There was a persistent belief until the present time that the developments in central banking that were taking place since the end of the War of 1914 were a temporary aberration and a resumption of old principles and practices would ultimately follow. But to-day after the War of 1939-45 there is hardly any ground for believing that the current trends would be reversed. Central Banking to-day is standing, as it were, at the cross roads and the signposts unmistakably point further ahead. There is no question of retracing its steps backwards. In Part One of the book an attempt is being made to stress some of the more important trends in central banking during the Great Depression and the Second World War and draw lessons, if any, from its experiences during the two periods.

The ten years preceding the outbreak of the War in 1939 witnessed a spectacular growth of central banking. As many as fourteen new central banks were created in countries which had none before, and there was hardly any civilised country which was not yet equipped with a central bank. Brazil, Venezuela and the Irish Free State were the notable exceptions but even in the case of all these countries, the establishment of new central banks was under consideration. In the first two countries draft bills had already been presented to the legislatures¹, while in the case of the third the Banking Commission of 1938 had recommended the conversion of the existing Currency Commission into a full-fledged central bank.² By the law of September 9, 1939 the Central Bank of Venezuela was established and it began operations in October 1940.³ The legislation establishing

¹ *Money and Banking* (League of Nations) 1937-38, Vol. II, pp. 39, 210.

² *Report of the Irish Banking Commission*, 1938.

³ *Money and Banking* (League of Nations) 1940-42. p. 196.

the Central Bank of Ireland was passed on November 4, 1942 and the new Bank superseded the Currency Commission on January 1, 1943.¹ The National Bank of Nicaragua was reorganised by virtue of a law of October 26, 1940, as a Central Bank.

A new spate of central banking activity was to be witnessed in war-time, as one country after another, was brought under German military occupation. When Yugoslavia fell to Germany, it was at once partitioned into Serbia (under German military occupation) and an "independent state" of Croatia. The National Bank of Yugoslavia was liquidated and in its place two new central banks were created, one in Croatia and another in Serbia. By a decree of the Chief of the "Independent State" a State Bank was established in Croatia on May 10th, 1941. But its statutes were not published till May 4th, 1943. In "Serbia" a "Serbian National Bank" was established by the German Military Commander on May 29th, 1941.² Earlier, the Bratislava branch of the National Bank of Czechoslovakia had been changed into a "National Bank of Slovakia" on April 4th, 1939 in the form of a joint-stock company with a share capital of 100 million francs of which 40 millions were taken up by a German banking group and 51 millions by the Slovak government.³

A careful examination of the statutes of the central banks created in the period between the depression and the War of 1939 is particularly revealing. Most remarkable departures will be found to have been made from the orthodox prescrip-

¹ *Federal Reserve Bulletin*, February 1943, p. 122.

² *Twelfth Annual Report of the Bank for International Settlements*, p. 204. Also *Money and Banking* (League of Nations) 1942-44, p. 220.

³ *Money and Banking* (League of Nations) 1942-44, p. 108. The German-held capital was repatriated in the beginning of 1944.

tions drawn up before the War of 1914 or even in the period immediately following it. This is true not only of the new central banking legislation but also of the amendments made in the period under review to the statutes of a number of old established banks. The years 1929 and 1939 constitute, indeed, important landmarks in the history of central banking development.

The structure of central banking came to be profoundly affected by the Great Depression. The developments in the years after the depression, no doubt, were partly its outcome but it would be misleading to suggest that they were wholly the product of an emergency situation.¹ Indeed some of the most important trends had already been observed in the post-war years ; they were merely accentuated in the years after depression. The new legislations, therefore, reflect currents of ideas which had steadily gathered force. In many respects they were the result of experience garnered by central bankers over a series of years. Changes had been rapidly taking place in the economic organisation—in the methods of financing domestic and foreign business. Possibly to keep themselves abreast of the times and to equip themselves properly for their task, the central banks were passing through a new phase of evolution.² The effects of the Second World War which has now ended have been no less remarkable and far-reaching changes have again been brought about in the laws and practices of central banks. These changes have been associated principally with the following developments : first, the pressure on government

¹ *Sixth Annual Report of the Bank for International Settlements* (1935-6), p. 56.

² *Ninth Annual Report of the Bank for International Settlements—* (1938-39), p. 119.

finances arising out of the enormous cost of modern warfare ; secondly, the urge for liquidity ; and thirdly, increased need of foreign payments for imports and other expenditures abroad.¹ The rumblings of a revolutionary change could be heard again.

CHAPTER II

LEGAL COVER RATIOS OF CENTRAL BANKS

One of the most striking trends in recent central banking legislation is the reduction of the legal cover ratio with a view to introducing greater elasticity in the employment of primary reserves. In the years immediately after World War I, the reserve ratio fetish had been greatly extended and during the decade 1922-32 there was a general tendency not only to raise the legal reserve requirements of central banks to 40% or even more but also to include sight liabilities in the calculation.

Gold and foreign exchange reserves of central banks have a two-fold function. One may be described as the "cover function" and the other as the "international currency function". The former helps to "support" national currency and credit structures. The latter provides the international currency which is needed as a "buffer stock" to meet discrepancies in the country's international balance of payments. The gold and foreign exchange which the law requires the central bank of a country to hold as "cover" against its domestic currency, clearly, will not be available

¹ *Tenth Annual Report of the Bank for International Settlements—* (1939-40), p. 1092.

at the same time for use as international currency. For the settlements of its foreign indebtedness, only the excess over and above the legal cover will be available for use. In the event of emergencies, therefore, legal minimum reserves are useless and for all practical purposes immobilised and frozen. The effect of legal reserve requirements, it has been rightly pointed out, has been to withhold a certain amount of gold and foreign exchange from the "international currency" function and to set it aside for an altogether different use, namely, the "cover function."¹ Whenever central banks are asked by law to increase their cover ratios, their position is not necessarily strengthened. Except in the case of a major cataclysm like that of a war, the public are practically indifferent to the question of the cover of bank notes : while in the event of such an upheaval even a cent per cent cover would not be able to sustain confidence in the notes. A legal "backing" of gold and foreign exchange adds little to the strength of a note currency in ordinary times.

Moreover, in an attempt to build up the large cover reserve, the central bank is often unable to provide an adequate reserve of international currency. It has already been noted that the surplus above the legal cover is the amount available for meeting a deficit in the country's balance of international payments. In practice the whole of this surplus even is not frequently available. A "cushion" so to speak is generally provided by the central banks above the legal minimum lest the law should have to be infringed. With a reserve ratio of 40%, for instance, the cushion may be another 5 or 7%. This cushion will tend to be virtually

¹ *International Currency Experience* (League of Nations), p. 95.

as immobilised as the legal minimum itself. It is the surplus reserve, therefore, which strengthens the position of the central banks, but the surplus reserves of central banks in the pre-depression period were, as Keynes put it, "uncomfortably small".¹ The entire amount of gold held as a statutory reserve and even a portion of the surplus held as a "cushion" were a dead asset and, in the picturesque language of a recent writer, might vanish into thin air or lie at the bottom of the sea without any consequence, provided no one knew.² However paradoxical it may appear, the more strictly and conservatively the gold reserves of a central bank are sought to be regulated by law, the weaker does it grow.³ In other words, the soundness of the position of a central bank depends not so much on its "cover" reserve as on its international "currency" reserve.

The size of the central banks' international currency reserves is governed by three important factors—the need for them, the desire to hold them and the power to build them up. The "need" refers to the possible range of fluctuations of the country's balance of payments. Agricultural exporting countries like India, Brazil and the Argentine would obviously need relatively large reserves owing to wide fluctuations of their balance of payments. But, being poor, they have been unwilling or unable to hold an adequate amount. The relation between the international reserves and domestic assets of central banks during the pre-and post-depression periods provides an interesting line of study. According to the so called rules of the gold standard game there ought to be a positive correlation between the inter-

¹ J. M. Keynes, *Treatise on Money* Vol. II p. 271.

² A. D. Gayer, *Monetary Policy and Economic Stabilisation* pp. 84-85.

³ J. M. Keynes, *Treatise on Money* Vol. II p. 272.

national and domestic assets, the movements of the two being parallel and concurrent. But as a matter of fact during most of the period 1922—1938 the correlation is found to have been negative, international and domestic assets having moved in the opposite rather than in the same direction. This inverse correlation was particularly in evidence during 1925—1928, the years of the restoration of the gold standard, and was the outcome, as in England, of a systematic policy of neutralization on the part of the central banks. In some cases, however, the negative correlation was due to the “inaction” rather than the deliberate “action” of central banks. In some other cases, as in Germany, Czechoslovakia, Austria and Bulgaria during 1924-29, it was due to what has been called “equilibrating” capital movements. In a few cases, as in France, the neutralization was not the result of a positive central banking policy but of “a whole range of social, political and fiscal contingencies.”¹ Bulgaria furnishes a unique case in the sense that it provides an instance of positive correlation over a subsequent period of seven years (1929—1935). The extreme unwillingness of the monetary authorities to part with gold is a probable explanation of their determination to reduce domestic assets and deflate credit concurrently with the loss of gold.

In contrast with the trend towards negative correlation of the pre-depression period, an actual increase in the frequency of positive correlation is to be witnessed after 1933, particularly in 1936. But this reversal of the trend could hardly be interpreted as a swing back to the rules of the gold standard game. In most of the cases the relatively greater frequency was due to an increase in both classes of assets, domestic and international. Monetary authorities took steps

¹ *International Currency Experience* (League of Nations) 1944 pp. 68-80.

to promote recovery from the depression just at the time when the world's supply of gold was increasing. This led to the simultaneous expansion of the two classes of the assets. But in 1938 there was hardly any case of a reduction in the international currency reserves of central banks not being neutralized by an increase in their domestic assets.¹ As a result of the recession, a large number of countries e.g. India, Australia, New Zealand, Peru, Sweden and the Argentine etc. experienced an unfavourable balance of payments and a consequent diminution in their external reserves. But this fall (in gold and foreign exchange reserves) was offset by an increase in the domestic assets (securities, discounts and loans) of the central banks concerned. Most of these countries were agricultural-exporting countries and it will be interesting to examine the manner in which the neutralization was brought about in some of them.

In the case of the Commonwealth Bank of Australia when during the recession of 1937-38, its foreign exchange reserve was reduced, domestic assets equivalent to double the amount of the decline were acquired. Such offsetting also took place in some other countries, as will be evident from the table given below :²

1938	Change in international assets as percentage of total international and domestic assets.	Change in domestic assets as percentage of total international and domestic assets.
Australia	—1'1	+ 2'1
Peru	—6'3	+17'5
Switzerland	—0'7	+ 5'6
Sweden	—2'6	+ 6'6

¹ *International Currency Experience* (League of Nations) 1944 p. 84.

² *Ibid.* Appendix IV, p. 237.

But such neutralization in most of these countries was one-sided as it was achieved in only one phase of the business cycle. Perhaps it was inevitable in poor agricultural countries. The Argentine in sharp contrast offers a remarkable example of a complete "cyclical neutralization" policy in both the boom and recession phases of the trade cycle. The inflow of foreign funds in the export boom of 1936-37 was sterilised through the sale of treasury bonds and certificates while the outflow of gold in the slump of 1937-38 was similarly neutralized by repurchasing some of the treasury bonds sold before with the result that the expansion and contraction in domestic credit were slight relatively to the changes in the balance of payments.¹

In 1936 the Reserve Bank of India's gold reserves amounted to Rs. 444,000,000 and its foreign assets totalled Rs. 840,000,000 ; while its domestic assets were Rs. 307,000,000. In 1938 the gold reserve remained unchanged but the foreign assets declined to Rs. 606,000,000 while the domestic assets increased to Rs. 470,000,000, as is evident from the table given below.

	Reserve Bank of India ²		
	Total domestic assets.	Total gold	Total foreign assets.
		(000,000 Rs.)	
1935	328	444	842
1936	307	444	840
1937	356	444	839
1938	470	444	606

Owing to an export boom in 1936-37 India's active merchandise balance of trade had increased to Rs. 77,13 lakhs

¹ *International Currency Experience*. p. 85.

² *Money and Banking 1939/37—1939/40* Vol. I (League of Nations) p. 130, p. 88.

from Rs. 29,86 lakhs in 1935-36. In 1937-38, the position deteriorated considerably and there was a passive visible balance of accounts in the first three months of 1938. The exchange began to fall and the Reserve Bank had to part with considerable amounts of its sterling securities in the Issue Department in an attempt to maintain the rupee-sterling ratio. But the deflationary effect of the loss of sterling reserves was offset by a lowering of the reserve ratio (ratio of "A" to liabilities). As Dr. B. N. Ganguli has shown, the contraction of the total note circulation was not as great as it otherwise would have been, as the percentage of "A" to note issue was allowed to fall. Indeed during May 27—July 22, 1938 contraction to the extent of Rs. 13,28,93,000 was avoided through a lowering of this ratio from 57.19% to 53.61%.¹

The Reserve Bank of India's acquisition of foreign exchange is found, from the following table, to have increased during June 1935 to March 1937. During the same period its holdings of domestic securities have, however, declined.

		Reserve Bank of India ²	
		Govt. of India Securities.	Foreign Exchange
April 5	1935	481	605
June	1935	445	715
Sept.	1935	309	802
Dec.	1935	308	836
Mar.	1936	295	904
June	1936	294	841
Sept.	1936	290	742
Dec.	1936	297	839
Mar.	1937	300	1,058

¹ B. N. Ganguli, *Whither Rupee?* pp. 30-33.

² *Money and Banking* (1936/37 Vol. II (Commercial Banks) p. 91.

But it will be misleading to suggest from these meagre data that the Reserve Bank deliberately pursued a policy of cyclical neutralization comparable in nature and extent to that of the Argentine Central Bank.

Opinion had been rapidly gaining ground in the early years of the Depression that the statutory reserves should be substantially reduced, if gold were to be used with full efficiency under a reformed international gold standard. It was frankly recognised that a lowering of the percentage from 40% to 33%, or even below it, would release a great deal of gold for active employment, enlarging the operative reserves by that amount. "The whole system of defined ratios," observed the Gold Delegation Committee, "has proved itself in the light of the special circumstances of post-war years to be too rigid and inadaptate. . . . We are of the opinion that it would be advantageous to reduce the reserve ratios from their present level."¹ The Minority Group of the Gold Delegation went further and suggested that the legal regulation of percentage reserves should be abolished.²

Then came the Monetary and Economic Conference of London in 1933. The unanimous recommendation of the Conference was that in order to improve the working of a future gold standard, greater elasticity should be imparted to the legal cover provisions of central banks by reducing the percentage gold cover to a minimum ratio of not more than 25%.³ The idea was not to permit the building up of a larger superstructure of notes and credits but to strengthen the position of central banks by increasing their free reserves. This recommendation gave concrete expression

¹ *Report of the Gold Delegation Committee* (League of Nations) p. 53.

² *Minority Report of the Gold Delegation Committee*, p. 71.

³ *Annual Report of the Bank for International Settlements*, 1936.

to a principle which had been gaining ground even before the Conference met. Experience had shown that even the country which possessed the largest stocks of gold, the United States, had twice found that the legal provisions were too inelastic in a period of sudden movements.

The statutes of a number of central banks had already been amended so as to make provision for a lower legal ratio. In August, 1932, the Austrian National Bank had reduced its minimum legal ratio from 24% to 20%. In Poland the minimum legal ratio against notes and other sight liabilities which had been 40% of gold and foreign exchange had been reduced under the new provisions of February, 1933 to 30% of gold alone against notes and other liabilities in excess of 100 million zloty.¹ Since 1933 the tendency for central banks to adopt a lower legal ratio is unmistakable. Not only have the statutes of several old established central banks been amended to provide for a reduced ratio but the newer central banks have increasingly adopted it at the outset. Under the Law of February, 1934, the National Bank of Czecho-slovakia adopted a 25% gold cover against sight liabilities in place of a 30% cover in gold and foreign exchange which existed in 1930 and which would have risen on the basis of the old graduated scale to 35% in 1935.² When the Bank of Canada was established by Act of Parliament in 1934, a minimum statutory reserve ratio of only 25% was adopted. By a decree of January 15, 1935, the reserve requirements of the National Bank of Yugoslavia which stood at 25% gold and 35% gold and foreign exchange were reduced to 20% and 25% respectively.³ As a result of the amendment of the statutes of

¹ *Third Annual Report of the Bank for International Settlements* (1932-33), p. 10.

² *Money and Banking* (League of Nations) (1937-38), Vol. I, p. 89.

³ *Federal Reserve Bulletin*, July 1936, p. 542.

the Bank of Danzig on 1st May, 1935, the legal minimum of gold and foreign exchange to be held against notes and other dues and liabilities was reduced from 40% to 30%. According to the decree of 13th January, 1936, the legal minimum cover in the case of the National Bank of Bulgaria was changed from 33 1/3% to 25%.¹ Under the original statutes of the Latvian Bank (Art. 13) the Bank was obliged to secure by gold or stable and sure foreign currencies at least 50% of the note circulation, if the total circulation did not exceed 100 million lats.² In May, 1936, the minimum cover was reduced to 30%.³ In terms of the provisions of the Act of July 12, 1907 (Art. 7, paras 1-3) the National Bank in Copenhagen was required to keep a metallic reserve equal to 50% of the nominal value of the notes in circulation. This reserve might consist of domestic legal tender gold coins, foreign gold coins and gold bullion.⁴ Under Sec. 10 of the New National Bank of Denmark Act, it was laid down that the gold fund should cover 25% of the total active note circulation.⁵ According to the Hungarian Monetary Legislation of 1924, the minimum cover of the National Bank was to rise to 28% in 1934. But such an increase was then considered to be untimely and it was decided to continue the older ratio for a further period of four years. When a reform of the central bank was effected by the Law of July 14, 1938, the minimum gold and foreign reserve was fixed at 25% of notes and other demand liabilities (excepting those to the govern-

¹ *Sixth Annual Report of the Bank for International Settlements* (1935-36), p. 10.

² *Legislation on Gold* (League of Nations), 1930, Table III, pp. 18, 97.

³ *Federal Reserve Bulletin*, July, 1936, pp. 544-45. Also *Seventh Annual Report of the Bank for International Settlements* (1936-37).

⁴ *Legislation on Gold* (League of Nations), 1930, p. 70.

⁵ "The National Bank of Denmark Act"—*Federal Reserve Bulletin* July 1936 p. 538.

ment).¹ Some of these countries reducing their legal cover ratios were debtor countries who sought to obtain some relief from the strain imposed by the depression on their balance of payments by utilising a portion of their cover reserves. There was not only a tendency to reduce the statutory reserves but even a marked trend of opinion against the very principle of reserve requirements. Both the Macmillan Committee and the Australian Banking Commission (1937) favoured the adoption of the system of note regulation known as the "absolute maximum" method prevalent in France till 1928. The Reichsbank of Germany and the Bank of Italy suspended their legal reserve requirements altogether in September 1932 and July 1935 respectively.²

The trend of opinion in favour of abolition of legal reserves was in close correspondence with the trend of fact. The supply of domestic money was hardly influenced by the statutory reserve ratios. It will be recalled that the practice of neutralization was widespread and persistent not only in the pre-depression but also in the post-depression period. The effect of such neutralization must have been to weaken the link between international currency reserves and national currency and credit, if not to snap it altogether.

The need for imparting greater elasticity into the reserve requirements of central banks became urgent in wartime not only for allowing increased lending to governments but also for releasing gold and exchange reserves for making foreign payments without a contraction of note circulation or banker's cash. Accordingly the statutes of almost all European central banks came to be modified on the outbreak of the War in

¹ *Money and Banking* 1938-39 (League of Nations) Vol. II p. 102.

² *Ibid* 1937-38 Vol. I p. 89.

1939 or shortly afterwards.¹ In many instances the legal cover ratios were relaxed or abolished altogether. In Germany, Italy and Greece they had been abolished even before the War. In 1940 the ratio was suspended in Canada. In the case not only of the newly created central banks but also in several of the older banks in German-occupied Europe, a most significant development was to frame (or amend as the case may be) the regulations in such a manner as to include Reichsmarks in the primary reserves against the note issue. As an instance of the former, the Serbian National Bank may be mentioned. The Reichsmark had come to occupy such a predominant position in the European foreign exchanges and central banks had adopted so wide-spread a practice of granting advances against clearing balances that the original reserve provisions of a number of central banks had to be modified. The Roumanian, Bulgarian and Nederlandsche central banks are cases in point. Sweden attempted to provide elasticity by including gold held abroad and by revaluation. The stock of gold in the reserves of many central banks had been so depleted and the note circulation had been growing at such a tremendous pace that changes in cover provisions had perforce to be made. In Belgium where the gold holding had become so negligible as to constitute a mere fictitious reserve, the reserve provisions were suspended until further notice by a decree of the German military commander in March 1942. In countries having the fiduciary method of note regulation, the legal limits were raised from time to time. In England the limit was raised from £300 million to £580 million on the outbreak of the war and the entire gold holding of the Bank was transferred to the Exchange Equalisation Account. There were thirteen subsequent increases which

¹ *Eleventh Annual Report of the B. I. S.* 1940-41 p. 176.

brought the fiduciary issue to £1250 million in December 1944.¹ The fiduciary limit has to-day ceased to possess its original significance. Formerly an approach to the limit was the signal for credit restriction and higher money rates as the necessary correctives. To-day the limit is exceeded whenever necessary. The negligible gold holding of the Bank of England also demonstrated that reserve requirements could be altered with ease without adverse effects on the state of confidence.

During 1944 the reserve provisions of the National Bank of Slovakia were relaxed and in the case of the National Bank of Belgium the reserve requirements were suspended to enable the Bank to use its gold stock for reconstruction purposes. But the case which has attracted the greatest measure of attention is that of the Federal Reserve Ratio. Under the Federal Reserve Act of 1913, a reserve of 40% in gold against notes and 35% in lawful money against deposits was provided, with a graduated tax on reserve deficiencies. In 1933, the existing reserve requirements were permitted to be suspended without tax penalty. In 1934 with the transfer of gold to the Treasury, gold certificates came to be substituted for gold at the Reserve Banks. In 1942 Federal Government securities were allowed to be utilised in place of gold for the "duration". For convenience the Reserve Banks show a combined ratio of reserves (almost entirely gold certificates) against the total of notes and deposits. Ever since the peak of 90·8% was reached at the end of December 1940 and maintained till December 1941, the Federal Reserve ratio has been declining continuously and even precipitately, as will be evident from the table given below.

¹ *World Economic Survey* 1942/44 p. 208.

TABLE¹

		Federal Reserve Ratio.			
1939	December	86·7	1944	March	61·6
1940	„	90·8	1944	June	56·3
1941	„	90·8	1944	September	52·9
1942	„	76·3	1944	December	49·0
1943	„	62·6			

The precipitous decline of the ratio from a high of 90·8 in 1940 to 49·0 in 1944 caused a great deal of concern in many quarters. Although it was still well over the legal minimum, it was perilously near the critical line, and it was believed that the market in government securities would collapse, as it did on two occasions before, when the reserve ratio had sunk close to the legal minimum, once in 1920 at the peak of the boom and again in 1933 for a few days. The declining ratio is to be found in the fact that the burden of financing the gigantic war fell chiefly upon the Reserve system. It resulted in the creation of an enormous quantity of new money in the hands of the public in the form of deposits and currency. This monetary expansion—to be precise, its nature rather than its total amount—was the principal cause of the falling reserve ratio.² The expansion of currency was spectacular. Prior to 1941 a continuous flow of gold had been replenishing the reserves of the member banks from which they could meet the heavy demand for currency. With the falling off in the gold inflow during that year, the reserves of the member banks declined. From 1942 onwards, therefore, the Reserve System had to shoulder the task of furnishing funds to the banks.³ Several methods were suggested from time to time

¹ *Fourteenth Annual Report of the B.I.S.*, p. 178.

² *Federal Reserve Bulletin*, March 1945, p. 215.

³ *The Economist*, August 19, 1944, pp. 250-51.

to alleviate the problem of the declining reserve ratio. But it was apparent that most of them were temporary and inadequate solutions. The real remedy lay in a reduction by statute of the reserve requirements. By an Act of Congress, June 12, 1945, the reserve requirements of the Federal Reserve Banks were reduced to a uniform minimum of 25% in gold certificates against Federal Reserve notes in circulation and deposit liabilities.¹

In the cases of the war-time revisions of cover provisions as in those of the post-depression period, the trend of ideas has been to regard gold and foreign exchange holdings as a reserve against payments abroad and to discard gold as an "internal" reserve strengthening notes in circulation. Perhaps the greatest damage to the prestige of gold as constituting internal reserve has been caused by the changed situations in England where the notes have come to be backed by an insignificant reserve of gold and in the U.S.A. where they are covered not by gold but by gold certificates. But the popular notion of an "internal reserve" of gold for imparting strength to a central bank's note issue dies hard and in some quarters a belief in the utility of such a reserve is still entertained. It is interesting to note in this connection how a central bank has found an "elegant," though perhaps an unorthodox, solution to the problem of internal reserves. For some years in Persia the crown jewels have been used to reinforce the metallic backing of the note issue and the jewels are being exhibited in show cases where the public may see them and be inspired with confidence.²

It must, however, be pointed out that the revisions of cover provisions that took place in wartime can not in all

¹ *Federal Reserve Bulletin*, July 1945.

² *Thirteenth Annual Report of the B.I.S.* p. 302.

cases be regarded as measures of monetary reform. In many instances they were measures of war economy. But one fact emerges as of outstanding importance. The recent modifications of central bank statutes have taken this familiar pattern : the cover requirements have been adapted to the increased note circulation, instead of the circulation being adapted to the legal requirements.¹ This is a definite break with traditional practice and law. A most interesting reversal of the current trend is to be witnessed in the new South African Reserve Bank Act of May 10th, 1944. The Reserve Bank would be under obligation to redeem its notes in gold, and an internal reserve of gold would be necessary for the purpose of redemption.²

In the background of this pronounced trend towards a lowering of the reserve ratio, it will be interesting to examine whether the Reserve Bank of India has considered a reduction of its minimum gold cover. Sec. 33 (2) of the Reserve Bank Act of 1934 provides that no less than two-fifths of the total assets of the Issue Department should consist of gold coin, gold bullion or sterling securities, the amount of gold coin and bullion being not less than Rs. 40 crores in value. The assets of the Issue Department have been divided into two classes—'A' consisting of gold coin and bullion and sterling securities and 'B' consisting of rupee coin, Government of India rupee securities and bills of exchange and other commercial paper. This gives us a ratio of 'A' to liabilities amounting to 40%. Some element of flexibility has been sought to be imparted to the statutory reserve ratio by including sterling securities but there is the minimum gold provi-

¹ *Twelfth Annual Report of the B.I.S.* p. 205.

² *Fourteenth Annual Report of the B.I.S.* p. 271. Also *Money and Banking* (League of Nations) 1942-44 pp. 190-91.

sion ; and the ratio of 40% may reasonably be considered to have been unduly high in the post-depression period. A lowering of the ratio would not only have given greater elasticity to the reserve but would also have helped to counteract, if necessary, a deflationary tendency. The importance of this aspect of the question has been clearly revealed in recent years. It will be recalled when the Reserve Bank's attempt to maintain the sagging rupee-sterling ratio led to a depletion of the sterling reserves, its deflationary effect could be offset to a considerable extent by reducing the ratio of 'A' to liabilities. It was allowed to fall to a figure which was still nearly 10% above the legal minimum.¹ This afforded some scope for avoiding contraction and even for expansion of note issue. But that scope may be considered to be much too limited for initiating an expansionist policy. In any attempt to initiate recovery of our country from the effects of the recession, the first step certainly was the provision of cheap and abundant bank credit. This could not possibly be achieved in a system where the central bank was constantly hampered by an anxiety to maintain large prescribed reserves. If the legal reserve ratio could then be lowered from 40% to 25 or 30%, the scope for expansion would have been considerably widened.

It may be pointed out in this connection that a revaluation of the gold stocks of the Indian Reserve Bank might also have afforded a wide scope for expansion. An examination of post-depression central banking legislation discloses that greater elasticity in the employment of the primary reserves was sought to be imparted not only through a reduction of the legal cover ratio but also through a revaluation of the existing gold holdings. The United States was the first

¹ B. N. Ganguli, *Whither Rupee?* p. 30.

country to revalue the central gold holdings in January, 1934. The American precedent was steadily followed by an ever-increasing number of countries. The National Bank of Austria followed immediately. The National Bank of Belgium revalued its gold reserves in the next year. When the gold bloc ceased to exist in 1936, Italy, Switzerland and France decided to revalue. The gold and foreign exchange holdings of the National Bank of Hungary were revalued by an amendment of its statutes in 1938. In the same year legislation was introduced in Finland with a view to revaluing the gold holdings of the Bank of Finland. The Eesti Bank revalued in March, 1939.¹ In the face of this remarkable trend towards revaluation of gold holdings by central banks throughout the world, the Bank of England which had continued to value its gold reserves at the old statutory price of 85s. per ounce reconsidered its position in 1939.

The Currency and Bank Notes Amendment Act of 1939, which came into effect on February 28, 1939, provided for a revaluation of the assets of the Issue Department. According to Sec. 2 (1) of the Act, "the assets held in the Issue Department shall be valued on the day on which the Act comes into operation and thereafter once in each week."² The Bank's return for March 1, 1939, revealed the incorporation of the provisions of the Act. The gold reserves which stood at £126.4 million on 22nd February, 1939, at the old price were written up to nearly £221 million on the basis of 148s. 5d. per fine ounce. Not only did a large number of countries other than those mentioned above revalue their gold holdings in recent years, such as the Argentine, Japan, Latvia, Roumania

¹ *Ninth Annual Report of the Bank for International Settlements* (1939-39), pp. 69-70.

² *Federal Reserve Bulletin* April, 1939, p. 271.

and Netherlands (March 1, 1940), but some of those cited above revalued for the third or even the fourth time (*e.g.*, France).

The legislations relating to revaluation of gold reserves have, as Mr. Robertson has pointed out, increased to an important extent the wide powers of manœuvre already possessed by the monetary authorities.¹ The Reserve Bank of India, however, took no steps to revalue its gold stocks after the manner of its *confreres* in other countries. Owing to its failure to revalue its gold reserves, the Reserve Bank came to be accused of being a party to deflationary tactics. In many quarters there was an insistent demand in the pre-war years for a mild measure of inflation through the revaluation of gold."²

CHAPTER III

WAR-TIME INCREASE IN NOTE CIRCULATION

An almost universal feature of war-time central banking has been a spectacular increase in its note circulation. This trend towards the expansion of note currency is to be witnessed even before the outbreak of the War in 1939. It was greatly accentuated after the outbreak and continued unabated throughout the course of the war. As regards the pre-war rise in note circulation, "higher amounts paid as wages and spent on consumption goods, larger amounts carried as cash by the individuals or held as reserves by commercial banks

¹ D. H. Robertson's Article in the *Lloyds Bank Monthly Review* May, 1939—"British Monetary Policy."

² See Mr. Manu Subedar's Article "Financial Injustice to India" in the *Indian Finance*, February 24, 1940, p. 425.

and other institutions, and an increase of hoarding affected perhaps by the new rates on deposits were among the most important general factors.”¹ With the approach of the War, the central banks came to participate more and more in the direct and indirect financing of their governments and the demands for liquidity on the part of the public also rapidly increased. The violent impact of the war brought about a sharp rise in note circulation. But the circumstances which led to this rise in the months immediately following the outbreak of hostilities were not identical in all countries and should be carefully distinguished. In one group of countries, such as the United Kingdom, Germany, the U.S.A. and Japan, the rise was merely a part of the general monetary expansion caused by actual or prospective war expenditure accompanied by increasing prices and turn-over. But in a large number of countries, such as Belgium, Norway, Egypt, Finland, Sweden, Roumania etc., the rise in note circulation took place not as the result of a change in the aggregate money supply but of a change in its composition. It was the outcome of conversion of bank deposits into cash.² This propensity to convert bank deposits into cash was due to various special factors such as evacuation of families tending to increase the number of separate cash holdings, wave of retail buying for purposes of hoarding, mobilisation of armed forces etc. This demand for cash liquidity, however, subsided in some countries after the first shock of the impact was over. In Canada, Hungary and South Africa the note circulation remained unchanged between October 1939 and January 1940.

In war-time the following additional factors were responsible for the increase in note circulation “The increase of

¹ *Eleventh Annual Report of the B.I.S.* p. 181.

² *World Economic Survey 1939-41* p. 20.

payrolls as a result of higher wages in the armament industries, prolonged working hours, and the mobilisation of fresh labour forces required more currency ; while soldiers were usually paid in notes and family allowances gave rise to many small payments : cash holdings of individual households increased further and the velocity of circulation was generally slowed down in trade and business circles by transport difficulties and the curtailment of banking facilities.”¹

In some countries special factors were in operation. The acquisition of new territories by Germany and the payments of wages to millions of foreign workers tended to increase the note circulation of the Reichsbank in the earlier years of the war. Like territorial changes, troop movements were an important factor making for an increase. The peculiar method of war financing adopted in India served to cause a phenomenal increase in the note circulation of the Indian Reserve Bank. The note circulation of the Bank of France rose owing to the increase of special advances to cover the costs of occupation. In England tax-evasion and increased black market dealings, in addition to the general factors, caused the sharp rise in the closing years of the war.

The increase in the note issue of central banks was brought about in different countries in different ways. In several cases the increase was brought about by the simple conversion of large amounts of cash held in the form of deposits already owned by private credit institutions. The basis of the increase in note circulation was provided in many instances by increasing the borrowing facilities available to governments from central banks, as in France and Germany. In yet other cases the basis was furnished by leaving the amount of gold

¹ *Twelfth Annual Report of the B.I.S.* p. 208.

reserves to the discretion of central banks or by including gold held abroad in the primary cover of the note circulation, as in Sweden in 1940. Lastly, the revaluation of the gold holdings of central banks provided the basis as in France, Netherlands and Yugoslavia.¹

The general expansion of note circulation will be evident from the table given below. Indices based on the average note circulation in the first six months of 1939 are available and will be found in the table² :—

	(Indexes of Note Circulations)						
	1939	1940	1941	1942	1943	1944	1945
U. K.	112	126	154	189	223	237	258
Germany	147	174	237	295	399	498	621
France	127	185	226	321	419	538	363*
Canada	122	169	223	313	393	449	455
New Zealand	125	134	160	200	245	246	260
India	124	128	181	305	444	497	616
Australia	119	142	177	258	345	413	390
U. S. A.	111	127	163	225	298	345	380
Roumania	130	172	258	314	428	566	

It will be interesting to notice that the increase in the circulation has varied from 312,422,000% in Greece to 25% in Uruguay. At the top of the inflation spiral will be found Greece and unoccupied China ; India, Iran and countries of S. E. Europe fall within the range of a 500 to 1000% increase followed by Germany. Australia, Canada and the U. S. A. come next while the United Kingdom occupies the lower end of the scale.³ A number of factors like taxation and borrowing from genuine savings plus a well organised com-

¹ *Tenth Annual Report of the Bank for International Settlements.*

² *Fourteenth Annual Report of the B.I.S.* p. 272. Also *Fifteenth Annual Report of the B.I.S.* p. 67.

* First balance-sheet after "exchange of notes."

³ *World Economic Survey (1942-24)* pp. 206-207.

mercial banking system served to hold in check an inflationary increase in England while the huge expenditure incurred by India on behalf of the Allies especially after the entry of Japan into the war in December 1941 caused the circulation to reach such a high figure. The note circulation has continued to increase in India still in 1944-45 but the rate of expansion has been declining since 1943-44. The rate of increase fell to 12% in 1945-46 as against 23% in 1944-45, 37% in 1943-44 and 69% in 1942-43 which was the highest recorded rate of rise.¹ In most cases the highest rate of increase of note circulation was reached about mid-1940 from which point a decline set in. At the end of 1941 most curves were again rising.² It was in Hungary that the greatest increase in note circulation took place in 1945-46. The Hungarian inflation outstripped even the German experience of 1923. Ever since the siege of Budapest which began in December 1944, inflationary processes had been gathering force and the climax was reached in the winter of 1945-46. People began to speak of "milpengo" for one million and "bilpengo" for one billion. The pengo was finally annihilated in July 1946 when it was decided to issue a new unit of currency, the "florint."³

Composition of Note Circulation :

A striking feature of this increase in note circulation has been a shift in the denominational pattern of the notes in circulation. In England, Australia, the U. S. A., India and in several other countries, notes of higher denominations expanded relatively to those of lower denominations. In the U. S. A., the notes of higher denominations comprising of 50

¹ *Reports on Currency and Finance 1944-45 and 1945-46.* Reserve Bank of India, p. 85, p. 105.

² *Twelfth Annual Report of the B.I.S.* p. 219.

³ *Sixteenth Annual Report of the B.I.S.* 1945-46 pp. 38-39.

dollars to 10,000 dollars increased by 45 p.c. in 1943 and 39 p.c. in 1944 ; while those of the smaller denominations comprising of one dollar to 20 dollars increased by 30 per cent. and 19 per cent respectively. The 20-dollar note had shown the greatest percentage increase compared with other denominations in 1941 but its place was taken in 1943 by the 50-dollar and 100-dollar notes. In Australia, denominations of £10 and £5 notes increased during 1939-44 by nearly eight and six times respectively as against a fourfold expansion in the total note circulation. In India, the proportion of Rs. 100 and Rs. 1,000 notes to total notes issued increased from 32.1 per cent and 5.9 per cent in 1939 to 34.9 per cent and 10.9 per cent in 1943. These two denominations together comprised 48 per cent in 1944 as against 46 per cent in 1943 and 38 per cent in 1939. Rs. 5 and Rs. 10 denominations dropped from 61 per cent in 1939 to 53 per cent in 1943 and 51 per cent in 1944. There has been an astonishing increase in the circulation of 1,000 rupee notes. From Rs. 13,79 lakhs in 1939 the circulation steadily rose to Rs. 90,99 lakhs in 1943, Rs. 100,93 lakhs in 1944 and Rs. 113,37 lakhs in 1945.¹ Notes of larger denominations in many countries have been generally used as means of payment in "black market" and other illegal transactions. Such notes are also hoarded to avoid payment of income and excess profit taxes.

Demonetisation of High Denomination Notes in India and elsewhere :

On January 12, 1946 the Government of India promulgated the "High Denomination Bank Notes Demonetisation Ordinance," depriving notes of the value of Rs. 500, Rs. 1,000

¹ *Report on Currency and Finance*, Reserve Bank of India 1944-45 p. 85, p. 95. Also *Report* 1945-46, p. 167.

and Rs. 10,000 of their legal tender character. As Sir Archibald Rowlands subsequently stated in the Central Assembly, the principal objects of the Demonetisation Ordinance were *inter alia* to strike at the blackmarketers, to rope in the tax-dodgers, to deprive public servants, who had betrayed their trust, of some of their ill-gotten gains and to bring under control a potential threat to a sound monetary system.¹ The Demonetisation Ordinance was preceded by another ordinance, the Bank Notes (Declaration of Holdings) Ordinance, which was promulgated earlier on the same day. This ordinance was intended to help the Government to form an estimate of the amount of notes of denominations of Rs. 100/- and above held by the banks relatively to the total circulation.²

As regards the exchange of the "high denomination" notes, the Demonetisation Ordinance prescribed an elaborate procedure so as to reveal the nature of the transaction through which the holder had obtained them. Every owner of a high denomination bank note desiring to tender it for exchange would have to sign a declaration form as prescribed by Sec. 6 of the ordinance. He would have to furnish in this form particulars regarding his name, status, address, the amount of his salary, if he was a salaried person, the nature and place of his business, profession or vocation etc, Reasons would also have to be given why the amount was kept in the form of high denomination notes rather than in bank deposits or securities.³

The activities in the black market and attempts at evasion of income tax and E. P. T. had been widespread in the country.

¹ Replying to Mr. Manu Subedar in the Legislative Assembly. *The Statesman* February 22, 1946.

² Press Note issued by the Government of India dated 12 January 1946.

³ Sec. 6 (2) of Ordinance III of 1946.

It was estimated that about Rs. 600 to Rs. 700 crores constituted the amount of "black-money" earned during the previous five years. Of this a large part, estimated at Rs. 300 crores, was believed to have been held as working capital of the black market, most of which was held in the form of Rs. 1000 notes.¹ A portion of the remainder had no doubt been already converted into gold, diamonds and real property but a part was certainly being hoarded in the form of high denomination notes. The ordinance should strike against the working capital as well as the cash hoards of the black market and thereby tighten the ring round it. Enormous amounts must have also been held in the form of such high denomination notes to evade the taxation authorities. It should no longer be possible to conceal the holdings from the income tax department and the taxdodgers would be brought to book at once. The Government took a step in the right direction and the ordinance should be welcomed. Indeed, it had long been overdue.

Immediately on the promulgation of the ordinances, the confusion and panic in the markets were very great. In the initial bewilderment there was an apprehension in many quarters that in a country where the banking habit was developing slowly and where the people were just beginning to regard paper money not only as a medium of exchange but also as a store of value, the effect of the ordinances would be to undermine their confidence in the currency system altogether. But this contention can be dismissed at once when it is remembered that Rs. 100 notes were reported to be selling at a premium in Calcutta, Bombay and elsewhere. The subsequent easy and almost automatic conversion of the notes

¹ *The Eastern Economist*, January 18, 1946 p. 90.

across the counter by the Reserve Bank must have repaired any damages that might have been caused to public confidence.

But there is another question on which there has been considerable loose talk. Will the effect of the Demonetisation Ordinance be deflationary in any way? There is a feeling that it will be so, for a large proportion of the "high denomination" notes may not be surrendered for exchange at all. Their holders would prefer to keep them and lose, rather than invite trouble by tendering them for exchange. The income-tax authorities, again, would at once pound upon those who surrendered; and a large amount of excess purchasing power could be mopped up through taxation of undisclosed incomes and profits. But to what extent the result will be deflationary will depend upon a number of factors. In the first place, a great deal will depend not only on the proportion of high denomination notes which will not be seeking exchange but on their proportion to the total notes in circulation and even to the aggregate liquid funds in the economy. In the second place, attention will have to be paid to the fact *whether further expansion of the currency is simultaneously taking place or not*. In the third place, it should be remembered that purchasing power embodied in the hoarded notes had, in any case, been immobilised. The holders would not have spent them upon ordinary consumption goods at all. If they were spent, they would have been used to purchase land, bullion, jewellery etc. It may be contended that the notes would have come out of their hoards into the market in the long run, if the ordinances were not passed. But we are not concerned with the long period effects. In the long run the problem of inflation in its present acute form may not exist at all. On the contrary, now that the ordinances were enacted,

a large portion of these notes would come out of their hoards and be presented for exchange either by their rightful owners directly or by their "holders" smuggling them through devious routes. To meet this demand for exchange, the issues of lower denomination notes might have to be increased. There would thus be hardly any contraction in the total volume of currency but merely a change in its composition. In the circumstances, the immediate effect of the Demonetisation Ordinance would be far from deflationary. The prices of land, bullion, diamonds etc. would rise immediately for there would be a flight from the high denomination notes into such goods. The prices of consumer goods may also rise for a large amount of postponable purchases would now be made as a result of the ordinances. But for the ordinances the high-denomination notes would not have been converted at all, at least for the present, and purchasing power embodied in them would have remained practically frozen. In the language of the *Economists' Manifesto*, monetary hoards that were previously dormant would now be made active.¹

As regards the proportion of the high denomination notes actually surrendered for exchange hitherto, the Finance Member revealed in the Central Assembly that the value of such notes in circulation on January 11, 1946, the day before the promulgation of the ordinances, was about Rs. 143,97,00,000. The total value of the notes exchanged before January 26, 1946 was Rs. 109,66,91,000. On February 22, in reply to Mr. Manu Subedar he observed that the amount so exchanged had by that time risen to about Rs. 117,55,00,000.² The total value of high denomination notes surrendered for exchange upto

¹ Indian Economists' Second Manifesto on Indian Financial and Currency Policy 4th February, 1946. *The Eastern Economist* February 15, 1946 p. 276.

² Sir Archibald Rowlands in reply to Mr. R. V. Reddiar and Mr. Manu

31 March 1946 amounted to Rs. 123,36,52,500.¹ In other words 81.6% of the total was surrendered upto 22 February and 85.6% upto 31 March 1946. In quantitative terms, notes of the value of Rs. 20,60,47,500 have not been surrendered for exchange and may be taken at the worst to be the maximum amount which may not seek conversion at all. As against this, it may be pointed out that the total note issue of the Reserve Bank which stood at Rs. 12,35,93 lakhs on 11 January 1946 rose to Rs. 12,47,73 lakhs on January 25. There was no doubt a small contraction of the total notes issued immediately after as will be evident from the figures of Rs. 12,45,76 lakhs on February 1 and Rs. 12,41,83 lakhs on February 15. But the deposits of the scheduled banks had been increasing all the time as the following table will show :²

	[In lakhs of Rupees.]		
	4th Jan. 46.	25th Jan. 46.	1st Feb. 46.
Demand liabilities	681,31	703,18	709,10
Time liabilities	279,15	286,58	289,83

In the background of the still increasing bank deposits and the already existing enormous amount of inflation, the small contraction of currency that has taken place and the little more that may take place in the near future, owing to some of the high denomination notes not being surrendered at all or owing to the absorption of some funds through taxation, will not be quantitatively very important. Any talk of deflation due to the demonetisation ordinances is ridiculous in the face of the enormous mass of liquid purchasing power now

Subedar in the Central Assembly. *The Statesman* 13th February, 1946 and *The Amrita Bazar Patrika* 23rd February, 1946.

¹ *Report on Currency and Finance*, Reserve Bank of India 1945-46 p. 115.

² *Reserve Bank of India's Weekly Returns*.

existing in the economy of the country which, it has been estimated, totals more than Rs. 2,500 crores.¹

The ordinances have been aptly characterised as a “key move” on the part of the government, deserving public support and sympathy. But in some quarters an attempt has been made to discover a sinister move behind them. It has been argued that the demonetisation of the high denomination notes is an attempt on the part of the government not only to accelerate the pace of deflation but also to scale down India’s sterling balances. The deflation, runs the argument, is necessary to set free a substantial portion of sterling securities which stand as a cover for the rupee currency, so that the same might be written off in the long run.* The argument is ingenious but highly misleading. Even if the motive of the government were so sinister, the Bank Notes Ordinances would be entirely unnecessary for the purpose of contracting the rupee currency in order that sterling securities might be safely written off. Three reasons may be adduced :

(1) Sec. 33 (2) of the Reserve Bank of India Act, 1934, provides that not less than two-fifths of the total assets of the Issue Department should consist of gold coin, gold bullion or sterling securities, the amount of gold coin and bullion being not less than Rs. 40 crores in value. That is, the ratio of ‘A’ (gold coin and bullion and sterling securities) to liabilities should not be less than 40 per cent. On the 30th March 1946, the percentage of gold and sterling securities together to total notes issued stood at 94.05 and was not below 93 per cent throughout the year 1945-46. The percentage is well above the statutory limit and a considerable amount of

¹ *The Eastern Economist* January 18, 1946, p. 92.

* Cp. Statement issued by the President, Eastern Chamber of Commerce.

sterling securities could indeed be written off before the statutory ratio was approached near enough.

(2) The gold holding of the Reserve Bank is still valued at the old statutory price of Rs. 21-3-10 p. per tola which is far below the market prices of gold. While a large number of countries have in recent years re-valued their gold reserves, India has not yet done so. A re-valuation of our gold reserves at the ruling prices of gold would more than provide an adequate cover for our note issue, even if a large portion of our sterling balances were liquidated or repudiated.

(3) Lastly, it will be recalled that ever since the last depression there has been a remarkable tendency for the legal cover ratios of central banks to be reduced much below 40%. Not only have the statutory reserves been reduced but there is a definite trend of opinion against the very principle of reserve requirements. In the light of recent developments in theory and practice, a 40% ratio may indeed be regarded as unduly high and may safely be reduced to 30% or even 25%. If the sterling balances are partly written off and as a consequence the ratio of 'A' to liabilities tends to approach the critical line, the remedy may be sought in the alteration of the statutory ratio itself. In that case the ratio will be brought in line with that prevailing in a large number of countries to-day.

With a view to preventing "black market" transactions, evasion of taxation and breaches of exchange control, steps had already been taken in some countries to call in notes of larger denominations and deprive them of their legal status. As early as April 1943, the issue of notes of £10 and upwards was discontinued in England. From 1st May 1945, outstanding notes of such denominations ceased to be legal tender. In the Netherlands, the steps taken by the German military authority in occupation were of a more

drastic character. In March 1943, all notes of the denominations of 500 guilder and 1,000 guilder were withdrawn and demonetised. The holders of such notes received, on surrendering, their equivalent in lower denomination notes only when taxes due from them were paid and careful enquiries were made into their position. It is interesting to notice that 730 million guilder out of a total of 870 millions in large notes outstanding were surrendered, 140 millions or nearly 16 per cent of the total not being tendered for exchange at all.¹ The presumption must be that the holders did not dare to surrender them as they must have been obtained through "black market" transactions or were being hoarded to evade taxation.

The exchange of notes has been a significant feature of the financial arrangements in the various liberated countries of Europe. The objectives as well as the procedures of such exchange have varied widely from country to country. In some places the authorities had no other end in view except a sifting out of notes taken by the enemy or otherwise unlawfully brought out of the country. In others the objectives have been more ambitious and have ranged from a confiscation of the hidden assets of war profiteers, blackmarketers and tax evaders, as already noted, to a special levy on wartime increases of capital and regulation of purchasing power through contraction. Belgium furnishes an outstanding instance of a country where the principal object of the exchange of notes was to effect a contraction in the available means of payment. Between April 1940 and September 1944, the volume of bank notes and deposits had increased there threefold. This enormous monetary circulation was considered to be much too excessive not only in relation to average

¹ *World Economic Survey* 1942-44 p. 209.

costs and prices but also in relation to the newly fixed exchange rate of B. fcs 176·625 to £=1. It was thought desirable to reduce the circulation to an amount compatible with the prevailing level of wages and prices. To achieve this end, the unprecedented step of sterilising the greater part of the volume of money by withdrawal and blocking was taken.¹ Under the decree of 6th October 1944, all notes of 100, 500, 1,000 and 10,000 francs had to be surrendered for exchange before 13th October. Each member of a household was allowed 2000 francs ; 40% of the remainder was temporarily "tied up", while 60% was blocked. Simultaneously all bank deposits were to be blocked except for 10% of the depositor's balance. Of the balance 40% was to be released gradually and 60% was to be blocked indefinitely. In May 1945 the government proposed to release gradually the balances which had been "temporarily tied up" and to transform the blocked balances into a forced loan. As a result of these measures the "free circulation" was reduced from 164 milliard B. fcs. to 57·4 milliard B. fcs. by the end of 1944. It subsequently amounted to 118 milliard B. fcs. through release of "temporarily tied up" funds and otherwise in August 1945.²

The immediate effect of the experiment was, however, to paralyse all sorts of transactions. In the face of a terrible shortage the "provisional", government was not strong enough to force down prices immediately. From the theoretical standpoint the experiment was hardly unsound. It had at least one very important effect, that of giving the whole Belgium economy an anti-inflationary orientation not only in regard to monetary circulation but also in regard to the level of wages. Increases in money wages could be kept

¹ *The Statist. International Banking Section*, November 25, 1944 p. 6.

² *Fifteenth Annual Report of the B.I.S.* (1944-45) pp. 60-61.

within relatively moderate bounds for a newly liberated country. In Denmark and Norway too, the purpose of the exchange was, apart from an "economic purge," to bring down the level of the note circulation. All notes in Norway above the denominations of one and two crowns were declared invalid from 9th September 1945. Of the notes presented for conversion 60% of the amount was to be credited to the holder on a current banking account and 40% on a "state account" which could not be drawn upon without a permit from the Ministry of Finance. In Finland and Czechoslovakia exchanges of notes together with a blocking of a portion of the old issues were also undertaken.¹

The exchanging of notes thus came to function as an interesting weapon of credit control, designed to influence not only the "quantity" but also the "quality" of money (since it aimed at a confiscation of ill-gotten money). But it must be observed that the volume of effective monetary demand in the country can not be affected by a mere blocking of a portion of the notes submitted for exchange. That volume must depend upon the level of current earnings in the shape of wages and salaries. Especially when the shortage is very great and official rations are hopelessly inadequate, the decree would hardly be of any avail for reducing the black market prices. That was the experience in Belgium and elsewhere. But as in Belgium, it can indirectly create a psychological situation in which increases in wages can be kept within moderate limits.^{2*}

¹ *Sixteenth Annual Report of the B.I.S.* (1945-46) p. 37.

² *Fifteenth Annual Report of the B.I.S.* (1944-45) p. 66.

* The substance of this section was published in the form of two articles by me in *The Nationalist*, January 15 and 21, 1946

The Concept of the "Average Note" :

To illustrate the shift in the denominational pattern of the notes in circulation, the method that has been adopted by the Reserve Bank of India is to calculate the value of the notes of each denomination as a percentage of the total circulation in each particular year. The table given below is taken from the Bank's *Report on Currency and Finance* !

Percentage to gross circulation of all notes
except Rs. 10,000.¹

	Rs. 1	Rs. 2	Rs. 5	Rs. 10	Rs. 20	Rs. 50	Rs. 100	Rs. 500	Rs. 1,000
1939	.1	—	19.4	41.9	—	.4	32.1	.2	5.9
1940	.1	—	18.3	40.6	—	.2	33.4	.1	7.3
1941	.1	—	18.3	39.7	—	.2	33.3	.1	8.3
1942	—	—	18.3	37.4	—	.1	34.8	.1	9.3
1943	—	.7	17.1	36.3	—	—	34.9	.1	10.9
1944	—	1.0	14.8	36.1	—	—	38.0	—	10.1
1945	—	1.2	12.8	35.3	—	—	41.2	—	9.4

But this method is not quite satisfactory. It is much too complicated and does not make international comparisons possible. A simple and more recent approach to the question is to be found in the concept of the "average note in circulation" which is being used to illustrate this international trend in the composition of note circulation. The "average note" is the quotient obtained when the aggregate value of all notes in circulation is divided by the total number of notes issued. On the base 1933-38=100, an index of the average note has been constructed. It can be shown that there has been an almost universal increase in the value of the average note outstanding, indicating a general shift in the centre of gravity towards the larger denominations.

¹ Statement XLIII, *Report on Currency and Finance*, Reserve Bank of India 1945-46 p. 167. [Rs. 10,000 notes are mainly used by banks for making large adjusting payments.]

Value of the Average Note in circulation¹

Average note (all denominations)

	France	U.S.A.	Denmark	Hungary	Sweden	Switzerland	Holland
1939	224	6'6	21'0	34'9	26'2	64'5	32'3
1940	199	6'9	22'1	31'1	26'5	65'5	30'8
1941	215	7'3	22'0	33'7	26'6	64'7	33'5
1942	248	8'0	22'9	40'7	27'4	64'2	33'3
1943	265	8'8	25'0	47'2	29'1	62'9	26'6

Average note adjusted (omitting small denominations)

1939	281	13'5	24'5	34'9	31'2	82'3	32'3
1940	283	13'3	25'8	35'9	32'3	83'8	30'8
1941	330	13'4	26'6	37'6	32'4	83'8	33'5
1942	379	13'5	27'6	41'0	33'4	86'4	33'3
1943	394	14'3	29'5	47'4	35'5	87'8	26'6

Index of Average Note adjusted (1933-38=100)

1939	122	104	117	116	118	103	102
1940	128	107	123	120	119	105	97
1941	144	107	127	125	119	104	105
1942	165	108	132	137	123	108	105
1943	172	114	141	158	131	109	84

The value of the "average note" is not to be found in the published statistics of the Reserve Bank of India. We have calculated the value of the average note in circulation in India from the data available in the *Annual Reports on Currency and Finance*. The value of the average note (all denominations) and of that adjusted (omitting the smaller denominations) is given in the following table. The trend will be found to be in line with the war-time international trend in this respect.

¹ *Fourteenth Annual Report of the B.I.S.* p. 288. (The values are expressed in terms of national currencies).

Value of the Average Note in circulation* [In Rs.]
Average Note (all denominations).

(Year ended 31st December)

1939	..	11'70	1942	.	12'79
1940	..	12'21	1943	.	12'86
1941	..	12'38	1944		13'27

Average Note adjusted (omitting Re. 1 to Rs.5
denominations).

1939		17	1942		19
1940		18	1943		20
1941	..	18	1944		21

The effect of the withdrawals of large notes through the ordinances will be reflected in a decline of the value of the average note as it has been in the case of Holland where the value declined from 33 to 27 florins.¹

Bank Deposits vs. Bank Notes :

Apart from the changing composition of note issues, another phenomenon of great significance accompanying the expansion of note circulation is that although bank deposits showed an upward trend in war-time, they declined everywhere in importance as compared with note circulations. For a number of countries the percentage of bank deposits to note circulations will be found to have declined. This decline though temporarily reversed as in the U. K. and the U. S. A. in 1940 is the continuation of a longer trend to be noticed even in the post-depression period.

* The values have been calculated by the writer from the statistics relating to circulation of notes by denominations in every year.

¹ *Fourteenth Annual Report of the B.I.S.* p. 290.

Bank deposits (Big Banks only) as a percentage
of note circulations.¹

	United Kingdom	U.S.A.	Germany	Finland	France	Sweden
1935	455	320	131	505	34	294
1936	431	315	118	458	32	282
1937	402	300	115	414	32	265
1938	386	308	89	442	30	262
1939	384	316	69	229	28	204
1940	391	318	77	214	28	194
1941	379	260	71	180	28	192
1942	336	217	66	162	24	171
1943	319	196	57	172	22	174

The percentage increases in bank deposits and note circulations are available for the United Kingdom, the United States, Sweden and Switzerland for the period 1939-45. Great differences between the two are to be observed as the following table shows :²

	Percentage increase	
	in deposits	in notes
U.S.A.	+146	+280
U.K.	+132	+158
Sweden	+ 50	+131
Switzerland	+ 15	+104

The table given below reveals the same declining trend in the case of India :

¹ *Twelfth and Fourteenth Reports of the B.I.S.* p. 213 & p. 298.

² *Fifteenth Annual Report of the B.I.S.* p. 69.

Deposits (Scheduled Banks) as a percentage
of note circulations.*

1935-36	134'4	1938-39	130'4	1942-43	79'9
1936-37	130'7	1939-40	117'0	1943-44	77'1
1937-38	129'9	1941-42	111'3	1944-45	80'4
		1945-46	82'04		

While the highest rate of increase in note circulation¹ occurred between October 1941 and September 1942 and the highest absolute increase between October 1942 and September 1943, demand deposits registered the highest rate of growth between April 1942 and March 1943 and the highest absolute increase between April 1943 and March 1944. As a result of the anti-inflationary drive of the Government of India, the rate of increase of note circulation dropped after April 1944 and was further reduced in 1945-46 owing to conditions brought about by the termination of the war. The rate of increase in note circulation was faster than that of deposits till the end of 1942-43. Later on, the increase in both came to be more or less of the same extent, the former rising by 87% and the latter by 89%. During 1945-46 notes in circulation rose by 12% only while deposits increased by 17%.¹

This war-time shift from deposits to notes is most remarkable as it has shown itself not only in countries where notes constitute the principal means of payment as in India, France, Belgium, Roumania etc. but also in countries where bank money constitutes by far the more predominant portion of current money as in England, Canada, the U.S.A. and Australia.

* Calculated from the data given in the *Report on Currency and Finance*, Reserve Bank of India 1945-46.

¹ *Report on Currency and Finance*. Reserve Bank of India 1945-46 p. 110-111.

The factors responsible for this change in the composition of total money supply are different in different countries. The general factors which tended to increase the war-time demand for note currency have already been indicated. The special factors which have tended to increase the percentage of notes to deposits in the total volume of money are the growth in employment and in the share of the national income going to the lower and middle income groups, who have typically made little use of bank accounts. These have been particularly important in the countries where deposits constitute by far the greater part of the total volume of money as in the U.S.A., England and Canada. The decline in interest rates which compelled banks not only to reduce deposit rates but also to make service charges, hoardings of currency due to fear and nervousness and the desire to conceal black market transactions have also supplied the motive power to hold cash rather than bank deposits. The absorption of deposits through subscriptions to large issues of middle and longterm bonds floated by governments in war-time has in no small measure accentuated the difference between the increase in note circulation and in deposits.²

Comparison of Note Circulation with National Incomes :

A third striking feature of the war-time increase of note circulation is that the percentage of the note circulation to the national income has tended to rise, especially after 1941 as will be evident from the table given below.³

¹ *World Economic Survey* (League of Nations) 1941-42 pp. 127-28.

² *Fifteenth Annual Report of the B.I.S.* p. 68.

³ *Fourteenth Annual Report of the B.I.S.*, p. 281.

Note circulations as percentage of national income.

	U.K.	Canada	Sweden	U.S.A.	Switzerland
1939	10'2	6'3	9'7	10'0	21'7
1940	9'7	7'0	11'9	10'2	23'8
1941	9'5	7'8	11'2	10'1	22'4
1942	10'6	8'0	11'3	10'7	23'0
1943	11'8	9'3	11'9	12'1	26'5

But in none of these countries is the rise so pronounced as to preclude the possibility of speaking of a relative stability in the proportion of note circulation to national income.

The *Fourteenth Annual Report of the B.I.S.* has made an attempt to bring out the trend in the relation between note circulation and national income over the period 1920-45 in the course of a graph. A definite uniformity in this trend is observable in the case of a large number of countries. The graph reveals falling curves in the 1920's, signifying that national incomes were increasing faster than note circulations, sharp rises in the early 1930's, when national incomes decreased without a corresponding change in the note circulation ; a subsequent decline lasting till about the outbreak of the war in 1939, as national incomes increased once again more rapidly than note circulation ; and lastly, an upward trend from this point. This pronounced war-period rise of the curves is of the greatest significance because it occurred just at the time when national incomes were rapidly expanding. It indicates an even more rapid expansion of note circulation.¹

The relation between note circulation and national income in India is most difficult to find for there are no reliable statistics of national income for our country.

¹ *Ibid.*, p. 283.

CHAPTER IV

RELATIONSHIP BETWEEN THE STATE AND CENTRAL BANKS

Perhaps the most revolutionary feature of recent central banking development is the altered relationship between the state and the central bank. This tendency stands in marked contrast with that of the period before World War I or immediately after it, when a great deal of emphasis was placed upon the desirability of maintaining and strengthening the political independence of central banks. There was hardly any other principle of central banking which was so much stressed as this freedom from state control and ownership. It was clearly expressed in the resolutions adopted at the Brussels Conference of 1920 and the Genoa Conference of 1922. It was embodied in the statutes of most of the central banks established or reorganised during the period of reconstruction after the first Great War.

The history of the relationship between the state and central banks makes an interesting study. That history reflects the gradual rise and subsequent decline of the doctrine of laissez-faire. After the principles of the laissez-faire philosophy had been applied to the economic sphere, they came to dominate several aspects of central banking until they pervaded the whole field of it by the middle of the nineteenth century. An inevitable corollary of the principle of laissez-faire was that if there was to be a central bank at all, it should be politically independent. The history of the Bank of England well illustrates the growth of this faith and

philosophy. The improvident ministries of the day courted as much the rich Old Lady of Threadneedle Street as the Lady herself sought their favours. The former were in quest of loans and the latter, of advantages at the time of the renewal of the charter. From these relationships between the Government and the Bank, certain incidents were carefully picked out to demonstrate an inherent incompetence of governments in the sphere of currency and credit control. This, it was argued, led to the irresistible conclusion that the central bank should be independent of government.¹ This trend of thought continued to develop till the outbreak of the War of 1914-18. In the years after that war this habit of thought gathered considerable force under the belief that the war had exhibited in extreme terms the dangers of state control and state direction of central banking.² Then "the tide strongly set against granting the state power to interfere with the functioning of a central bank", and almost all the central banks that were established in the post-war period were made by statute free from government control and ownership of capital. The exposition of conservative central banking theory has stressed this political independence of central banks as one of its primary tenets.³

In more recent years it has come to be increasingly recognised that governmental competence in currency and credit regulation has been under-estimated while that of the central banks has been exaggerated. Instances of currency mismanagement and abuse by governments in the past have been frequently quoted but it would be misleading to suggest that

¹ *American Economic Review Supplement*, March 1944 Art. by K. R. Bopp, p. 262.

² Parker Wills, *Theory and Practice of Central Banking*, *op. cit.*

³ See Kisch and Elkin, *Central Banks* (1932), p. 2, p. 27.

political interference in the money market produced the more important monetary debacles. The governments had to interfere under conditions where orderly finance was impossible and it may be contended that under fairly stable conditions, state management of currency and credit would be no more dangerous in its effects than a number of other state activities.¹ Indeed many instances may be found where this power to issue money has remained with governments for long periods but has not been abused. Incidents from the early history of the Bank of England have often been used to support the doctrine of governmental ineptitude and the central bank's competence. But Prof. Viner has pointed out that during 1800-1860 the Bank of England showed on several occasions "an inexcusable degree of incompetence and unwillingness to fulfil the requirements which could reasonably be demanded of a central bank."² It was the government which, on the other hand, displayed its competence when it forced the Bank to reduce its rate from 5 to 4% in the deflation of 1822 and took the initiative in increasing the circulation in the same year.³

The history of central banking is replete with instances of conflicts between governments and central banks. The conflicts generally arose when the governments insisted on an expansionary credit policy and the banks were disposed towards contraction. When governments were forced to borrow extensively from the banks in wartime and inflations were generated, they were inevitably blamed. So long as depressions were regarded as an "act of god" or due to natural law, the banks naturally escaped criticisms. In

¹ A. F. W. Plumptre, *Central Banking in the British Dominions*.

² J. Viner, *Studies in the Theory of International Trade*, p. 254.

³ R. G. Hawtrey, *A Century of Bank Rate*, p. 14.

more recent years when easy money policy has been considered to be appropriate in periods of depression, the governments have come out with a much better record than the banks. Ever since the last Great Depression, there has been, in marked contrast to the established traditions, a major swing of the pendulum in favour of increased control and ownership of central banks by the government. It had become evident, that monetary instruments by themselves were quite ineffective in curing or preventing a depression and to stimulate recovery more direct methods on the part of the government were called for. Partly as a result of the ineffectiveness of monetary instruments and partly as a result of their characteristic attitudes and narrow perspectives, central bankers had made many decisions which empirically were unfortunate. "The economic indeterminateness of a correct monetary policy for any specific situation had become apparent." In the formulation of monetary policy itself, a set of new criteria, altogether different from those operating under traditional gold standard conditions, had to be substituted. The clash between international and domestic interests came to be resolved by subordinating considerations of external equilibrium to those of internal economic stability. As a recent writer has forcefully put it, the inevitable result was that the doom of the independent central bank was sealed and the mirage fostered so carefully in the 1920's that in troublous times finance and politics could be kept apart was destroyed by the Great Depression.¹

In the years immediately following the depression there took place a remarkable movement towards state ownership and state control of central banks. This movement could be witnessed in the conversion not only of old established

¹ G. G. Johnson, *The Treasury and Monetary Policy*, 1933-38, p. 6.

central banks, functioning hitherto as private shareholders' institutions, but also of newly created central banks, within a few years of their inception, into state banks.

The National Bank in Copenhagen originally founded as a State bank in 1813 was changed into a private shareholders' bank in 1818 and functioned in this form independently of the State for more than 100 years. By the Law of 7th April, 1936, it was nationalised and transformed into Denmark's National Bank. The shareholders received as compensation 54 million kronor (which was equivalent to twice the nominal value of the shares) in 4% bonds issued by the new Bank for this purpose and guaranteed by the State. The Government provided a general capital fund of 50 million kronor in the form of a certificate. By degrees as funds out of the annual profits would be allocated to the guarantee fund, corresponding amounts were to be written off the general capital fund certificate.¹

The Reserve Bank of New Zealand is an outstanding example of a nationalised central bank, if not because of its subservience to the Government, at least because of the unequivocal way in which this has been laid down in the constitution.² When the Reserve Bank Bill was introduced for the first time in 1932, the proposed Bank was conceived on orthodox lines and, in accordance with Sir Otto Niemeyer's recommendations, was to be controlled by a Board "entirely free from the actual fact and fear of political interference." The Bank was established on August, 1, 1934, as a private shareholders' bank by the Law of November 27, 1933. But important departures were made from Sir Otto's

¹ The National Bank of Denmark Act, No. 416, April 7, 1936—*Federal Reserve Bulletin*, July, 1936, pp. 537-40.

² *The Bankers' Magazine*, April, 1939. "The Reserve Bank of New Zealand"—Article by H. R. Randerson, p. 580.

scheme for the Act made provisions for a substantial measure of political control. The Board of Directors came to be composed not only of four shareholders' 'directors' but also of the Secretary to the Treasury and three State directors and the Governor and the Deputy Governor, all of whom were to be appointed by the Governor-General in Council. Although the Bank was established with wide government powers over it, yet the monetary reformers were not satisfied. The Labour Government, by passing an amending Act on April 8, 1936, placed the Bank virtually in the position of a Government department. The shares were cancelled and the holders were given in exchange Government stock or cash computed on the market valuation of the shares. Every vestige of private control was completely removed ; the Secretary to the Treasury who did not previously possess a vote was given one ; the Board of Directors were to serve at the pleasure of the Government. All previous restrictions on the power of the Bank to buy and sell long-term Government securities were removed ; and the Bank was authorised to underwrite any New Zealand Government loan, advance the full amount of the Treasury's estimated revenue and discount Government bills.

The Bank of Canada was established in 1935 as an entirely private shareholders' bank. Under the Law of 23rd June, 1936, the State assumed partial ownership of the Bank by increasing its capital by issuing 102,000 shares of Class B at the par value of \$50 each to the Minister of Finance.¹ By

¹ *Federal Reserve Bulletin*, October 1936, pp. 789-92. Sec. 17(1). The Bank of Canada Amendment Act, 23rd June, 1936. "The capital of the Bank shall be ten million one hundred thousand dollars consisting of one hundred thousand shares (Class A) issued to the public and one hundred and two thousand shares to be issued to the Minister at par (Class B) to be held by him on behalf of the Dominion of Canada and to be paid for out of the consolidated revenue funds."

the Bank of Canada Amendment Act of June 1, 1938, which came into force on August 5, 1938, the Bank was nationalised. Sec 17 (1) of the Act provided that the capital of \$5 million should be issued to the Minister to be held by him on behalf of the Dominion of Canada. Under Sec. 17A, the Minister was to exchange 100,000 Class B shares out of 102,000 held by him for 100 shares of the capital of the Bank which it had been authorised to issue. The Bank was to pay to each holder of Class 'A' shares of the Bank the sum of 59 dollars and 20 cents for each Class 'A' share. The Minister would re-imburse the Bank the amount by which payments made by the Bank to holders of Class 'A' shares exceeded the par value of such shares and such re-imbursement should be effected by surrendering to the Bank for cancellation 2,000 of the Class 'B' shares held by the Minister, having the aggregate par value of one hundred thousand dollars, and by paying to the Bank out of any unappropriated moneys in the consolidated revenue fund the sum of eight hundred and twenty thousand dollars.¹

When a new central bank was formed in Paraguay by a decree of 23rd February, 1936, out of the existing Bank of the Republic of Paraguay, a private owned commercial bank, it was State-owned.² By the Law of 12th March, 1936, the Bank of Italy was transformed into a "public law" institution and the private shareholders were repaid the old capital.

Although the old Reichsbank was privately owned, it was operated and controlled by the Government. This long association of Government control was broken by the Law of 1924. The new Bank was created as a privately owned

¹ The Bank of Canada Amendment Act of 1st July, 1938—*Federal Reserve Bulletin*, August, 1938, pp. 652-54.

² De Kock, *Central Banking*, p. 284.

joint-stock company to be controlled by its own Board of Directors and the charter stressed its independence of State control.¹ But when the statutes of the Bank were amended by the Law of 10th February, 1937, the provisions regarding its independence were eliminated and its Directorium was placed directly under the Fuhrer and Chancellor.² New law seeking to bring the transformation of the Reichsbank, which had begun with the Law of 10th February, 1937, to a conclusion in conformity with the National Socialist principles was promulgated on 15th June, 1939. Sec. 1 (1) definitely laid down that the German Reichsbank should be responsible to the Fuhrer and Chancellor of the Reich.³

The trend towards State control of central banks during the period under review is reflected not only in the ownership of their capital but also in the increased participation in their administration. In several instances where no alterations were made in the ownership of the capital, a substantial measure of direct and indirect State participation in the appointments of Governors and Directors of central banks is to be observed in the recent amendments to the statutes. In the Bank of Greece, the Cabinet of Ministers began to appoint the Governor, the Deputy Governor and the Sub-Governor from 1932, all of whom previously had been elected by the General Meeting of shareholders. The composition of the council in the case of the Bank of France was radically changed by the Law of 24th July, 1936. A General Council was substituted for the old Regency Council and the State was empowered to make a number of appointments.⁴ One

¹ M. B. Northrop, *Control Policies of the Reichsbank*, p. 29.

² *Sixth Annual Report of the Bank of International Settlements*, p. 95.

³ *Federal Reserve Bulletin*, September, 1939, pp. 737-42.

⁴ De Kock, *Central Banking*, p. 286.

of the three members of the Board of Governors of the newly transformed State Bank of Denmark was to be nominated by the King. He should also be the chairman of the Board.¹ In the U.S.A. all the members of the Board of Governors of the Federal Reserve System are being appointed to-day by the President ; and the appointments of the Presidents and Vice-Presidents of the Federal Reserve Banks themselves are also subject to the approval of the Board.²

This trend towards increased State control and participation is manifested in a different manner in the growing interference by the State in the policy of the central banks and in the pressure exerted on them for financial accommodation. A most interesting feature of this development has been that this intervention has not been resented by the central bankers as an infringement of their freedom and independence. On the contrary, they have frankly expressed their willingness to mould their policy in accordance with the wishes of their Governments. There was hardly any central banking institution which was legally more independent of Government control than the Bank of England but we find its Governor assuring the Ministers in the course of a statement made in 1936 that the Bank was always willing to do loyally and with goodwill what they would direct as if it was under legal compulsion.³ The Bank had become the technical instrument for carrying out the monetary policy of the government and a source of technical information and advice. This assurance was re-affirmed by the Governor a year later in the following words. "We must look largely to the Chancellor of the

¹ Sec. 6, The National Bank of Denmark Act, 7th April, 1936—*Federal Reserve Bulletin*, July, 1936, p. 537.

² Article in the *Journal of Political Economy*, December, 1935, by H. H. Preston—"The Banking Act of 1935."

³ See *The Economist*, 10th October, 1936.

Exchequer, and we assure him that in all matters his requests govern the conduct of our affairs.”¹

Apart from the domination of the Treasury in matters relating to monetary and banking policy, the central banks were increasingly subjected to the constant pressure for extension of financial facilities to the State. The Great Depression and the subsequent abandonment of the gold standard over almost the entire world brought about a chaos in Government finances and the central banks had to meet the increased demands for accommodation. On 14th April, 1938, a convention was entered into between the French Minister of Finance and the Governor of the Bank of France which increased by 10 billion francs the amount of advances that might be granted by the Bank to the French Treasury.² When the statutes of the Bank of Poland were amended on 13th February, 1939, advances to the State were raised from 100 million zl. to 150 million zl. In Germany the Law of June 15, 1939 concerning the Reichsbank removed the limit which was fixed at 100 million RM. for working credits to the Finance Ministry and left that to be determined by the Fuhrer and the Chancellor.³ An examination of the balance sheets of many central banks in the period under consideration is particularly revealing. Large holdings of Government securities and Treasury bills, as well as direct State debts will at once leap up to the eye.

During the war, owing to its exigencies, this trend towards state control of central banking came to be considerably accentuated. This is reflected in the emergency powers

¹ *Money and Banking* (League of Nations), 1937-38, Vol. I, p. 83 ft. note.

² *Federal Reserve Bulletin*, August 1938, pp. 650-51.

³ *Tenth Annual Report of the B. I. S.*

obtained by governments to alter by decree central banking regulations. The Defence (Finance) Act in England and the Swedish Law of December 22, 1939 furnish good instances in this respect. The control of the government over the Reserve Bank of New Zealand which had begun since 1935 was considerably tightened in war-time with the passing of the Reserve Bank Amendment Act as a part of war finance legislation. Under its provisions the Governor and the Board of the Bank were required to give effect to government decisions and the Minister of Finance was empowered to vary the reserve ratio.¹

The trend towards state ownership of central banks noticed in the post-depression era is continued during 1939-40 and subsequent years. By the decree of August 3, 1939, the Central Bank of Bolivia was nationalised. The government which had previously owned nearly 60% of the shares of the Bank now became the sole stockholders.² The whole character of the Japanese central bank was changed by a law of March 1942 from a semi-official institution into an official state body (although still with private shareholders).³ The capital of the Central Bank of Ireland established in February 1943 was entirely supplied by the government.⁴

It is interesting to notice, however, that the reduction of the formal independence of central banks has been compensated to a considerable extent by an enlargement of the scope of their activity. With the centralisation of authority in times of emergency, the central banks have come to acquire

¹ *Tenth Annual Report of the B. I. S.*

² *Money and Banking* (League of Nations), 1942-44, p. 91.

³ *Twelfth Annual Report of the B. I. S.*, p. 200.

⁴ *Federal Reserve Bulletin*, February 1943, p. 122.

new functions which government departments are not as fitted to carry out as the banks themselves are, because of their intimate connection with money and exchange markets. Again when government controls ramify into the previously uncontrolled sectors of national economy and pressing financial and fiscal problems call for immediate solution, the role of the central bank as adviser to the government becomes increasingly significant.

As in the depression period, so in wartime central banks came to be subjected to increasing pressure, on the part of the government, for financial accommodation. On the outbreak of the war, the most important task of the central bank in belligerent and neutral countries alike was to finance the special needs of the state. As a consequence, central bank statutes and practices were modified and the legal limits fixed in previous years for granting advances to governments were raised in several cases; and the banks were authorised to extend further credits to them. A most interesting instance is provided by the Bank of France where the limits fixed for special advances to the French Government to cover the costs of military occupation were raised successively from 50,000 million francs in 1940 to 426,000 millions in 1944.¹ But the French method of direct advances has not been the only means of financing extraordinary state expenditure in wartime. The discounting and rediscounting of treasury bills has also been frequently adopted.

This trend towards State ownership and State control as reflected in current central banking developments should be carefully noted in our country. There has been a wide-spread

¹ *World Economic Survey 1942-44*, p. 183.

demand for State Banks in India for a long time and it may be recalled that the first Reserve Bank Bill foundered on the rock of the question of independence of political control. At that time State banking institutions in the world were very few in number and this was one of the strongest points in favour of the shareholders' type of central banks. But circumstances have entirely changed since those days. The number of State banks has been steadily on the increase and during the last few years the trend towards State control and ownership as shown above has been unmistakable. In the pre-war days there were at least 12 central banks whose capital was fully owned by the State besides a large number where it was partially owned. They were the Riksbank of Sweden, Bank of Finland, National Bank of Denmark, National Bank of Bulgaria, Bank of New Zealand, Bank of Canada, Central Bank of China, Bank of the Republic of Paraguay, Bank of the Republic of Uruguay and the National Bank of Costa Rica.¹ As we have already noted, a few more have come to be added to the list since the war.

The old and rusty weapons from the armoury of the State bankers need not be brought out again to support the case for a State-owned central bank in India. Recent developments in foreign central banking should help to revise our notions in regard to the constitution of central banks. Even if they failed to afford any lesson to the protagonists of the shareholders' type of banks, developments nearer at home, within our own country, cannot certainly be ignored. When the Reserve Bank of India was inaugurated, the Government intended to make it a truly representative shareholders' bank by keeping the electorate as wide as possible. Accordingly

¹ De Kock, *Central Banking*, p. 265.

when the Reserve Bank issued its capital, it accepted only applications for between 5 and 50 shares. The limitation to 50 shares of the maximum voting power of an individual has the same thing as its objective.

During the first seven years of the inauguration of the Reserve Bank of India, the total number of shareholders declined from 92,047 in April 1935 to 57,192 in June 1942. The average number of shares held by each shareholder increased from 5.4% to 9.8%. Not only the total number but the distribution of shares among the different provinces underwent significant changes. There was an increasing drift of shares to Bombay. Her original holding amounted to 140,000 shares. They increased to 218,649 mainly at the expense of Calcutta and Delhi. The holdings of Calcutta declined from 145,000 to 119,991 and those of Delhi from 115,000 to 85,762.¹

From the figures given above, one fact of startling importance at once leaps up to the eye. The Reserve Bank is well on its way to lose its status of a public institution. The concentration of shares in the hands of a small number of shareholders of a particular province will strike at the root of the intentions of the government to maintain the electorate as wide as possible. In a recent Report of the Central Board of Directors of the Reserve Bank, a pointed reference was made to this tendency for the bank shares to be concentrated in the hands of fewer people and the possibility of domination of the central bank from a particular centre. The Bank reported the position to the Government of India and as a result of its recommendation that the number of shares held by an individual should be limited to a maximum of 200 and

¹ Report of the Annual General Meeting of Shareholders, Reserve Bank of India, August 1942.

that no transfer should be registered in the name of any individual in excess of that amount, the Reserve Bank of India Act was amended. It is difficult to see how this tendency could be checked by legislation. The Amending Act would hardly enable the Government to attain the desired objective. Several members of one family may buy up to the legal maximum and control of the complete block of several hundred shares may remain in the hands of an individual. As a matter of fact, the total number of shareholders has continued to decline and the number of shares on the Bombay area has continued to expand at the expense of other areas in subsequent as in previous years.¹ The following table strikingly reveals the progressive decline in the total number of shareholders and the steady increase in the average number of shares held by each shareholder since 1st April 1935.²

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Number of shareholders.

April 1, 1935	June 30, 1942	June 30, 1943	June 30, 1944	June 30, 1945	June 30 1946
2,047	51,171	49,402	48,292	46,640	45,692

Average number of shares held by each shareholder.

5.4	9.8	10.1	10.4	10.7	10.9
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The number of shares on the Bombay area has also

¹ *Report of the Eighth General Meeting of Shareholders* (Reserve Bank of India) 10 August 1942, pp. 8-9.

² *Reports of the 9th, 11th and 12th Annual General Meetings of Shareholders* (Reserve Bank of India), p. 9, p. 7, p. 7.

continued to expand at the expense of other areas, as will be evident from the figures given below.¹

April 1 1935	June 30 1942	June 30 1943	June 30 1944	June 30 1945	June 30 1946
Bombay—					
1,40,000	2,18,649	2,25,022	2,31,133	2,33,272	2,36,321
Calcutta—					
1,45,000	1,19,991	1,19,243	1,19,247	1,21,755	1,24,629
Delhi—					
1,15,000	85,762	87,163	85,137	82,930	79,220
Madras—					
70,000	58,810	58,096	55,273	53,159	51,042
Rangoon—					
30,000	16,838	10,476	9,210	8,884	8,788
5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000

Hence the entire purpose of the Act appears to have been defeated. One solution—and we believe it to be the real solution—at once suggests itself. The central government should buy out the shareholders altogether and own the Reserve Bank itself as has been done in the case of several countries in recent years.

Apart from the question of the distribution of shares, the functioning of the Reserve Bank during the past ten years has not been such as to justify the claims put forward in favour of a shareholders' bank. The case for a shareholder's type of bank chiefly rested on the fact that it would ensure a free choice of directors. An electorate of shareholders electing freely the directorate would keep it immune from political

¹ *Ibid.*, p. 9, p. 8 and p. 7. The number of shares on the register of the Calcutta area has tended to increase during 1945 and 1946.

interference. But as the *Indian Finance* has observed, it is clear from the elections during the past decade that in actual practice the directors have elected themselves as well as their successors. Vested interests have firmly entrenched themselves in the shareholders' plan. The record of achievement of the Central Board in regard to policy has not been such as to inspire much confidence in their judgment. Finally, the manner in which the personnel of the Bank have been selected suggests no difference between the administration of currency and credit through the old department of the Controller of Currency and that through the present Reserve Bank.¹ In the context of the planned policy of a stable level of employment and production to which our Government, along with Governments abroad, are committed in the post-war years, the case for the public ownership of the Reserve Bank is certainly stronger to-day than it has ever been before. With the nationalisation of the Bank of England, the last plank in the argument for foisting a shareholders' bank upon India gives way. Now that a National Government has assumed office in India, there should be no difficulty in nationalising the Reserve Bank.

It is interesting to notice in this connection that recent debates in the Indian Legislature revealed a general consensus of opinion in favour of nationalisation of the Reserve Bank. This desire for nationalisation was principally on the ground that an institution playing such a vital part in the economic life of the country should be nationalised so that a proper co-ordination and integration of the currency, credit and monetary policy with the government's financial and economic policy may be secured. The cornering of the

¹ *Indian Finance*, September 1, 1945, p. 377.

Bank's shares by a small section in one part of the country was also a factor which influenced the course of the debates. But the strongest feeling was excited by the failure of the Reserve Bank to help the non-scheduled banks during the recent banking crisis in Bengal. The limitations of the present Act under which the Reserve Bank had to work were stressed and the Bank was severely criticised for its inability to discharge its functions and obligations properly. The Finance Member frankly recognised that the feeling of the House was very strong on the subject and promised to give a sympathetic consideration to the proposal for nationalising the Bank, if this was found to be in the best interest of the country.¹ He declared subsequently in his Budget Speech that he had carefully considered the matter and was convinced that any possible disadvantages of nationalisation would be more than counter-balanced by the advantages. He concluded finally that the Reserve Bank should be nationalised.²

We have been urging the nationalisation of the Bank for a long time and we greet the Finance Member's announcement with unconcealed satisfaction.³

CHAPTER V

NATIONALISATION OF CENTRAL BANKS AND POST-WAR POLICIES OF FULL EMPLOYMENT

(With the end of the war, in the background of post-war economic planning and full employment policies, the question of the status and structure of central banks has assumed a

¹ *Legislative Assembly Debates*, 20th February, 1947.

² *Budget Speech 1947-48*, 28th February, 1947.

³ *The Calcutta Review*, May-June 1940.

new aspect. Particular attention came to be focussed on it, ever since the British Labour Party had declared its policy of "socializing" the Bank of England. The party had long felt that there were strong reasons for depriving the Central Bank of independence in matters of policy. Such independence, it was contended, would lead the Bank in the future, as it had led it in the past, to take an exceedingly narrow view of its functions and duties. Further, the old idea of keeping politics and finance separate should be abandoned. It should be frankly recognised that politics and finance overlap and their administration must overlap. Lastly, no government could raise the nation's standard of living, if the central bank stood in the way.¹ For a long time it had generally been known that one of the first tasks of the future Labour Government of England would be to nationalise the central bank of the country.² In the closing years of the war when "full employment" began to figure as the most important objective of post-war economy, a new orientation was given to the labour policy in this respect; and true to expectations, immediately after the assumption of office by the Labour Government, the Chancellor of the Exchequer introduced the "historic" bill for the nationalisation of the Bank of England. The nationalisation of the Bank was to take precedence over that of the mining, power and steel industries.

The Bank of England has been universally regarded as the most, and perhaps the only, independent central bank of the world at the present time. It has always prided itself on

¹ A. B. White, *The Nationalisation of Banking* pp. 25-32.

² Cp. Lord Addison's Speech in the debate on the International Monetary Fund in the House of Lords on 23 May 1944. "It is essential in the future that the national control of finance policy should remain within the government of the country and must not be the business of any semi-independent private corporation."

this remarkable feature. In the circumstances, the Bank of England Bill inevitably excited a great deal of interest and not a little controversy. The question of nationalising central banks in the post-war economy of full employment may be best examined in relation to the significant change that has been brought about in the status of the Bank of England.

The Bank of England Bill, as it has been "demurely" put, "to bring the capital stock of the Bank of England into public ownership and bring the Bank under public control" was introduced in Parliament on October 10, 1945, two hundred and fifty one years and three months after Sir John Houblon was chosen as their first governor by the Proprietors.¹ Dr. Dalton's bill to nationalise the Bank was no doubt the first public sponsored bill but nearly a generation ago one Mr. Maxton had a bill for the nationalisation of the Bank printed. The Examiner of Petitions for private bills, however, found that it failed to comply with standing orders and it was thrown out.² The tentative clauses of Mr. Maxton's bill relating to the buying out of the proprietors are of some interest at the present moment. Under their provisions, the shareholders were to get a 5% stock. Dr. Dalton's bill, however, provided that the proprietors would be bought out in exchange for Government stock bearing interest at the rate of three per cent. per annum and redeemable at par by the Treasury on or at any time after 5th April 1966 after giving not less than three months' notice in the *London Gazette* of their intention to do so.³ The amount of Government stock to be issued to any holder would be such that the annual interest was equal

¹ *The Statist*, October 13, 1945 p. 866.

² Sir John Clapham, *The Bank of England. A History* Vol. II, p. 420.

³ Cl. 1(2) and (3) *The Bankers' Magazine*, November 1945 p. 293.

to the annual gross dividend during the period of 20 years ending on March 31st, 1945. On this basis, the Government would pay £400 stock for each £100 stock of the Bank. The holders would be assured the same income they had been getting from the stock during the last twenty-two years, namely 12%, but henceforth the guarantee of the state would be behind it.¹ The Governor, Deputy Governor and the sixteen Directors constituting the Court were all to be appointed by the Crown, i.e. by the Ministry.² The Governor and the Deputy Governor would be appointed for five-year terms and the directors for four-year terms. The five-year term for the Governor was a departure from the traditional two years and under modern conditions appears to be a healthy change.³ The affairs of the Bank were to be managed by the Court of Directors, subject to directions given by the government in the public interest. But these directions would be given only "after consultation with the Governor."⁴ Lord Catto, the present Governor, revealed that it was at his request that these words were deliberately inserted in the clause.⁵ All these features of the bill have been rightly characterised as features of nationalisation in its least unpalatable form⁶ and have generally been non-controversial. But Cl. 4 (3) which sought to give new powers to the Bank of England over the commercial banking system excited a great deal of controversy and even encountered serious opposition in several quarters. The clause ran as follows, "The Bank,

¹ *The Statists*, October 13, 1945 p. 866.

² Cl. 2(1) and (2) of the Bank of England Bill.

³ *The Economist*, October 13, 1945 p. 514.

⁴ Cl. 4(1) and (2).

⁵ Speech of Lord Catto in the House of Lords, January 22, 1946. *The Statesman*, 25 January 1946.

⁶ *The Economist*, October 13, 1945 p. 532.

if they think it necessary in the public interest, may request information from and make recommendation to bankers, and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation."

The Bank of England Act received the Royal Assent on February 14, 1946. On March 1, the appointed day set by the Treasury, the Bank began operations as a government institution.

The question of the nationalisation of central banks raises two important issues which should be kept separate. First, will the change-over produce any material effect on the practical working of modern central banks? Will it not simply be a *dejure* recognition of a *defacto* state of affairs, particularly in the case of a central bank like the Bank of England? And secondly, will not the change in status and structure be necessary to fit the central bank for its new functions in the post-war planning for full employment?

As regards the first question, it may be recalled how intimate have grown the relations between the Treasury and central banks in recent years. In the past the views of the Bank of England carried considerable weight because it was a separate institution, and not a Treasury Department. But in the present times, there have been hardly any differences between the Bank and the Treasury on questions of monetary policy. On its 250th birthday, the Bank "in whose half-unconscious and sometimes rather unwilling hands", the principles and practices of central banking were originally worked out, had evolved into a position, as Sir John Clapham has observed, "closely analogous to that of a Port of London

Authority, an Electricity Commission, a Railway Board, if such a thing were ever made, the position, that is, of an organisation functioning in close contact with those in political authority but not controlled by them continuously and in detail : neither wishing nor needing to have its conduct affected by considerations of maximum profit." To-day, to quote the eminent historian once again, it is already "a non-competitive public institution with world wide connection and influence, not eager for profit but anxious faithfully and honestly to demean itself according to the best of its skill and understanding" and "to be indifferent and equal to all manner of persons."¹

A careful examination of the Bank Act makes it plain that the Government have not been much inclined to effect any revolutionary change. Every significant feature of the present central banking organisation that is not incompatible with government ownership of the Bank has been sought to be retained. Great pains appear to have been taken by the Government not to impair the delicate central banking mechanism that has been evolved over the past years. Indeed the basic merits of the present system have been recognised in the decision to retain the "Court" instead of replacing it by a panel of advisers as in Australia. Further, it is evident that the inner reserves of the Bank will not be raided by the government and it will be able to accumulate fresh reserves as freely as possible. The only payment that the Bank will have to make to the government is the half-yearly equivalent of what the Treasury will have to pay to the holders of the

¹ Sir John Clapham, *The Bank of England. A History* Vol. II, pp. 426-427.

new Government stock.* The Bank will also receive an agreed payment for management of this stock.**

In the light of the position as analysed above, it may be argued, as the City Editor of the *Evening News* has done, that the Bank of England is already in substance a nationalised institution and the formal taking over by the State would make no material difference. It would simply bring into legal form what has for many years been the accepted practice, and, as Lord Bradbury has put it, would "do no more than put the saddle on the right donkey's back." *The Economist* has also contended that the catalogue of changes are no changes and the Bank of 1946 will not differ significantly from that of 1945.¹

But although the Government have hitherto had a great influence in the affairs of the Bank, its whole tradition, as Mr. Cole has observed, is that of "a great City institution, belonging to the world of high finance rather than to that of Government and proud of its independence *vis-a-vis* the State."² The traditional power of the City to influence Bank policy through proprietorship will be gone and the Governor will constitute the sole "buffer between Whitehall and Threadneedle Street."³ The relations between the Bank and the Government have been akin to those of a treaty rather than of subordination. In the event of a clash between the Government and the Bank, the word of the former has not always prevailed. This was amply demonstrated in 1931

* "In lieu of any such dividends the Bank shall pay to the Treasury, on every fifth day of April and October the sum of £873,180 or such less or greater sum as may from time to time be agreed upon between the Treasury and the Bank." Cl. 1(4) *The Bank of England Act, 1946*.

** First Schedule Cl. 2. *The Bank of England Act, 1946*.

¹ *The Economist*, February 16, 1946, p. 259.

² G. D. Cole, *Money, Its Present and Future*, p. 193.

³ *The Statist*, October 13, 1945.

when the Bank called upon the Government to reduce their unemployment expenditure. Even though the last word might have been with Whitehall, politically the Bank has been independent of parliamentary control. It is here that the most fundamental change is likely to take place. Dr. Dalton has observed that in the last resort as between the Treasury and the Bank of England, the last word would have to be with the Treasury after due consultation with the Governor in case of disagreement.

Another change, equally important and possibly of graver significance, relates to the fact that henceforth the credit of the Bank of England will be tied to the apron strings of the British government. Dr. Dalton himself admitted that the Bank had built up for itself a unique position by managing its affairs prudently for so many years. But the record of the Treasury is otherwise. To-day it has to borrow from the U. S. A. an amount as large as \$3,750,000,000, so that it may be able to balance its budget and pay its debts abroad. The credit of the British government and its reserves are far lower than they had ever been before. If the credit of the Bank is tied in this manner to that of the Government, it will, as Mr. F. W. Hirst emphatically observes, "suffer irretrievably".¹

But it was the provisions of sub-section (3) of Clause 4 of the Bank Bill which had caused the greatest perturbation in the City. Not only did the City apprehend that they would bring about a radical change in the structure of British banking but it also scented danger lurking under them. The Central Bank under this clause was given new and very wide powers over the commercial banking system. The Bank was

¹ F. W. Hirst, "The Budget and the Bank Bill." Art. in the *Contemporary Review*, December, 1945 pp. 324-325.

empowered to request information from and make recommendations to bankers as well as issue directions, if authorised by the Government. No doubt the Bank had made "requests" in the past and they had never been lightly treated by the City. Indeed the whole fabric of credit control would have crumbled to pieces, if the unwritten conventions forming its basis could not ultimately be enforced. But the initiative for these "requests" and "recommendations" came from the Bank, and not from the Government. That part of the clause which gave the Bank power to issue directions to commercial banks with Treasury sanction came under the heaviest barrage of criticism. In the first place, it was feared that it would infringe the legitimate secrecy of the banker-customer relationship. In the second place, it was apprehended that the reconstituted central bank was being endowed with formal powers of control over joint-stock banks in furtherance of the policy of the Labour Government.

As regards the first point, Dr. Dalton indeed assured the House during the debates on the Bill that it was not aimed at forcing the disclosure of any confidential information about private bank deposits. Implementing his promise, by way of amendment a qualifying phrase was also added to the controversial subsection: "Provided that no such request or recommendations shall be made with respect to the affairs of any particular customer of a banker."¹ Although the government may be genuinely inclined not to pry into private banking accounts, yet, as the *Economist* has pointed out, the clause even when amended will not prevent the Bank from taking action "with respect to" a group of customers, however

¹ *The Bank of England Act, 1946* Cl. 4, 3(a). *Journal of the Institute of Bankers*, April 1946, p. 131.

small.¹ Moreover, the group may be so defined as to reveal in broad terms the position of an individual customer. The clause could be improved by so phrasing it as to preclude the Bank from framing its request in such a manner or form as to reveal information about individuals. As regards the second point which is much more serious and alarming, Mr. Hirst has contended that the aim is to reduce the whole banking system into subjection so as to subserve the ends of the Labour Government, to subserve, in other words, "the purpose of converting what before the war was a free country into a bureaucratic socialist state."² The Chancellor no doubt conceded during the passage of the Bill that no directions would be issued without previous consultation with representatives of the bank in question, who would always be able, when a direction was in prospect, to contact the Treasury direct in the presence of the Governor of the Bank of England.* But Dr. Dalton would in no case accept any limitation on the scope of the powers themselves.

In the government's view, the wide powers deliberately conferred under the clause with the authority of the Treasury behind it were essential to assure the successful working of their five-year plan. "The Treasury, the central bank and the clearing banks would have to pull well together." It is plain the object of the Bank of England Act goes far beyond the central bank itself. Requests, recommendations and directions are in law as well as in intent very far from being restricted to the mere eliciting of information. Dr. Dalton's

¹ The *Economist*, December 8, 1945 p. 838.

² F. W. Hirst in the *Contemporary Review* *op. cit.*

* "Before authorising the issue of any such directions the Treasury shall give the banker concerned, or such person as appears to them to represent him, an opportunity of making representations with respect thereto." Cl. 4(3) (b) *The Bank of England Act, 1946.*

observations indicate that the powers over the commercial banks aimed, among other things, to ensure priorities in the disposal of short-term funds corresponding to the power relating to long-term funds that would be sought when the National Investment Board was set up. Banks may be directed to devote their resources to particular lines of investment which in the opinion of the Bank of England and the Government are necessary "in the interests of a planned priority, with a view to securing full employment and building up export trade and other necessary elements" of the national economy.¹ Prof. Laski in broadcasting to the U. S. A. on Labour Policy on the eve of the election had used the expression "socialization," in preference to the more usual one of "nationalisation," of the Bank of England. Even then one could read into it an intention far more ambitious than the mere bringing of the Bank under control. Whatever doubts there might have been as regards the extent to which the Labour Government were prepared to go, these have been set at rest by the manner in which such wide powers have been taken over the commercial banks under Cl. 4.(3) of the Act.

As regards the second question, from the point of view of a planned policy of full employment, much closer relationships between the government and the central bank than what obtain under the system of private shareholders' banks are not only desirable but absolutely necessary. Central Banks should become Public Corporations, duly owned by the public and managed by public servants appointed by the government with perhaps a sprinkling of non-official representation. The

¹ *The Economist*, December 22, 1945 p. 941. Also February 16, 1946 p. 260.

buying out of the Bank's proprietors is necessary not because the proprietors are of direct importance but because in an ordinary shareholders' type of Central Bank, the Directors are formally responsible to them and are formally appointed by them. It is not intended for a moment that the "socialized" Central Bank would be subjected to day-to-day control of the Treasury or of the Parliament. Treasury interference must be definitely limited to what is required for ensuring the Bank's agreement with the general economic policy of the government. Monetary policy plays so vital a part in government's general economic policies that it can no longer be kept "outside politics" to-day. The present-day rôle of the central bank as banker to the government will be radically changed when in the post-war economy it will have to ensure that the supply of the means of payment should be adjusted to the need of their employment plan. The link to the government should be much closer. It is well known what an important rôle has been ascribed to-day to deficit spending as a method of achieving and maintaining full employment. One of the fundamental problems related to the creation of employment by this method is the question of maintaining the rate of interest at a stable level. If the rate of interest is forced up under the stress of a budget deficit, the stimulating effect of government spending upon employment will be neutralised by a decline in private investment. The rate of interest may be prevented from rising, if a proper banking policy is followed. The essence of this policy is for the central bank to expand the cash basis of the member banks so that they may expand their deposits sufficiently and maintain at the same time the prescribed or customary reserve ratio. When the government is pursuing a policy of full employment by means of deficit financing, it must be sure that the

rate of interest is definitely under its control and can not be raised against it. The control over the rate of interest is exercised by the government, not in its capacity as a "borrower" but in that of a "controller" of the central bank.¹ The central bank inevitably becomes a part of the government machine and this position of the central bank may be formalised by its complete nationalisation.

But in such circumstances the connection of the Bank should be with the Ministry for Planning and Development rather than with the Treasury. The Chancellor of the Exchequer is responsible for the budget dealing with tax revenue and current expenditure only while the Planning Member is responsible for the other one dealing with capital expenditure and borrowing for economic reconstruction and maintenance of employment at a high level. It is clear that the nationalised central bank should be closely linked with the Ministry of Planning and Development.²

In the post-war economy the question of nationalisation of central banks will assume special importance. The position of gold will have to be decided upon, the relationship between the various currencies of the world will have to be settled, and international agreements will have to be made. Such international agreements will inevitably be between governments and not between central banks. Now that the proposals for the I.M.F. have been accepted, the position of the central banks will be one of subordination to the governments. As Lord Keynes has pointed out in the House of Lords, the International Monetary Fund is an organisation

¹ See *The Economics of Full Employment*. "Three Ways to Full Employment" by M. Kalecki, p. 42 ; "Public Finance—Its Relation to Full Employment" by E. P. Schumacher p. 112.

² G. D. H. Cole, *Money, Its Present and Future*, p. 197.

between governments in which central banks only appear as agents and instruments of their governments.¹ The positive co-operation of central banks with their governments in the circumstances may have to be ensured by "nationalising" them so that they may form an integral part of the public machinery of economic regulation in the field of international as in that of national affairs.

The complexion of governments in the foreseeable future in most countries is likely to be Labour and Socialist. There is a definite movement away from Conservative and Liberal ideals and a swing towards the left. The policies of Labour Governments and of central banks, not subordinate to governments but privately owned and independent, are likely to be in conflict. The difficulties that arose in England in 1931 with a Labour Government in power have already been mentioned. Even more serious difficulties were witnessed in France during the Blum experiment of 1936-37.

In connection with the New Deal of the Roosevelt administration, it has even been suggested in some quarters that the President's banking reforms of 1933 had not gone far enough and his inability to submit the banking system to closer public control must have been largely responsible for the failures of his policy. The essence of a policy of this type was for the state to assume conscious control of the volume of money in the economy ; and public ownership and public control of the banking system would have been its logical corollary. *There is no doubt that the uncontrolled political*

¹ Parliamentary Debates. House of Lords (1943-44) Vol. cxxxi (Speech of Lord Keynes in the debate on the International Monetary Fund dated 23rd May, 1944), p. 843.

power of Wall Street influenced to a considerable extent the shape of events.¹

Besides England some other countries have also taken steps to effect important structural changes in the relationship between the state and the banking system. The object has generally been to fortify public control over the banking system and in doing so to exclude the influence of sectional interest.²

The Australian Socialist Government had already "nailed its flag firmly to the mast of national control of the banking system." They had brought the Commonwealth Bank under public control by passing the Commonwealth Bank Act in August 1945. A Banking Act was also passed at the time. In Australia, as in England, the commercial banks will remain in private ownership, but will be subject to a large measure of control exercised through the Commonwealth Bank. They will have to furnish such information as will be required by the Commonwealth Bank but a direction to give such information shall not require the furnishing of information regarding the accounts of individual customers. It is interesting to notice that the corresponding clause in the Bank of England Bill was inserted only after a prolonged debate. The Commonwealth Bank may further determine the lending policy of the ordinary banks which are themselves precluded from buying or subscribing to Commonwealth, state or other securities listed on an Australian stock exchange. The Bank has been divided into a number of sections, the various departments being the Central Banking, the Note Issue, the

¹ H. W. Arndt, *The Economic Lessons of the Nineteen-Thirties* pp. 36-37.

² *Fifteenth Report of the Bank for International Settlements*, p. 69.

Mortgage Bank, the Rural Credits Dept., the General Banking Division and the Industrial Finance Dept.¹

The recent nationalisation of the Bank of France under the law of December 2, 1945, is significant in that it came as part of a more comprehensive plan to introduce state ownership and state supervision of financial institutions. This law imposed special control over all business banks with total assets exceeding 500 million francs and provided for the nationalisation of four out of the "Big Six" deposit banks. The last step stands in sharp contrast to the procedure in England and Australia where the commercial banks are to remain still in private ownership. As regards the expropriation of the shareholders of the Bank of France, the basis of compensation is also markedly different from that adopted in the case of the Bank of England. Market values, rather than dividends, have been chosen by the French Government as the basis of compensation. The shareholders will receive registered negotiable bonds delivered by the Bank, the redemption value of which shall be equal to the liquidation value of the share as determined by a particularly constituted commission. The liquidation value, however, shall not exceed the average quoted price during the period September 1, 1944 to August 31, 1945.² The principle of capitalisation of past dividends was deliberately rejected as it was calculated to produce a capital value wholly out of line with the values of shares in war-time.³ So long as governments are socialistic, nationalised central banks, as nationalised industries, will thrive well. But with a change in the complexion of governments, they may not function so effectively.

¹ *The Statist, International Banking Section*, December 8, 1945 p. 13.

² Law No. 45-015 of December 2, 1945. *Federal Reserve Bulletin* May 1946, p. 483.

³ *The Economist*, December 8, 1945, pp. 835-836.

In conclusion, it may be observed that it matters very little whether the several thousand investors hold government stock or bank stock but it matters a great deal whether nationalisation will increase or diminish the central bank's capacity to do its technical job. The more far reaching the government's general economic policy and the wider the area of public control and ownership of industry, the more important it becomes for the Minister of Finance to have his finger on the pulse of the private financial organisation. The central bank is that "pulse". The whole crux of the matter is whether the nationalised central bank could continue to be the pulse in the same degree.¹

CHAPTER VI

OPEN MARKET OPERATIONS OF CENTRAL BANKS

Another significant trend to be observed in recent central banking legislation is the extensive authorisation of central banks to undertake open market operations. In the days before World War I, it is well known, the Bank of England engaged in few operations which would be termed "open market" to-day. Open market operations in the modern sense were practically unknown. The practice of "selling consols spot and buying for the account" was never very frequent and was hardly an important addition to the Bank's armoury. The Reichsbank of Germany was the only other central bank which undertook operations bearing a resem-

¹ *The Economist*, August 4, 1945, p. 164.

blance to the modern open market operations. Although the Federal Reserve Act of 1913 had permitted open market operations, yet they came to be developed as a systematic policy only since 1923. It was only in the years after the War of 1914-18 that open market operations came to assume their significance and the Bank of England and the Federal Reserve System began to place greater reliance upon this particular method of credit control. In the Continent the scope of open market operations was considerably restricted even in the years after the War of 1914 and the French observers did not hesitate to describe such operations as an "Anglo-Saxon vice."¹ Indeed a large number of the older central banks were still prohibited by law from undertaking open market purchases and sales of Government bonds, treasury bills and similar securities for their own account. The central banks in Holland, Norway, Belgium France and Germany were notable instances in point. In the post-depression years the statutes of several old central banks were modified so as to enable them to engage in open market operations while in the case of the newly established central banks provisions were made in their statutes in many cases for powers to undertake such operations.

It is only in recent years that the question of open market operations as a method of credit control has come to receive attention in countries outside England and the United States. The Reichsbank of Germany was the first among the older central banks to be endowed with the power of open market operations. In October, 1933, it was authorised to buy and sell certain specified securities. Though purchase and sale of bank acceptances had been included under the discount

¹ Parker Wills, *The Theory and Practice of Central Banking with special reference to the Federal Reserve System*, p. 178.

business of the Bank and had been a part of its regular business, purchase and sale of Government bonds was denied to it as a control device because such transactions were definitely restricted under the charter of 1924.¹ It was not permitted to purchase Government bonds on its own account ; it could purchase a limited amount for the investment of its pension funds. But this amount was too small to be of any significance. The purchase of Reich short-term treasury bills had also been prohibited by the same charter. By an amendment of the charter in 1926, the Reichsbank was permitted to discount, buy and sell such bills of not more than three months currency, up to the amount of 400 million RM.; but the Reichsbank made no use of this privilege until 1928. At any rate the total amount of short term treasury bills permitted was too small relatively to the total amount of money outstanding to be of any use for quantitative control of the money market. Deprived of its major prop *viz.*, open market operations, the discount policy of the Reichsbank had become in its hands a blunt and ineffective weapon of credit control.² The new Law of the Reichsbank promulgated on June 15, 1939, definitely envisaged open market policy as an instrument of central banking control for it empowered the Reichsbank to buy and sell, *in order to regulate the money market*, fixed interest-bearing securities which were admitted to official trading on the stock exchanges as well as treasury bills which were due within one year from the date of purchase.³ By an amendment to its statutes on February 6, 1935, the Bank of Poland was authorised to buy for its own account public

¹ M. B. Northrop. *Control Policies of the Reichsbank*, p. 35.

² M. B. Northrop, *Control Policies of the Reichsbank*, pp. 268-69.

³ Sec. 13(1) Reichsbank Law of June 15, 1939, *Federal Reserve Bulletin*, September, 1939, p. 738.

securities and mortgage bonds quoted on the Warsaw Stock Exchange up to 150 million zł.¹ By an amendment to the statutes in 1939, the maximum was raised to 200 million zł.² By a law of 30th June, 1935, the Norges Bank (Norway) was empowered to carry on open market operations. Under the provisions of the Law of 22nd February, 1937, the Nederlandsche Bank was given the power to engage in open market operations. The operations were to consist in the buying and selling of bills accepted by banks or bankers established within the Netherlands and of treasury bills, the latter to be bought from third parties. The Swedish Law of March, 1937, authorised the Riksbank to undertake open market operations by stipulating that the Riksbank might obtain short-term Government securities from the National Debt office with a view to selling them in order to withdraw surplus funds from the market.³ When the statutes of the Belgian National Bank were reformed by the Royal decree of July 23, 1937, the Bank was authorised to engage in open market operations so that it might fulfil its function as a regulator of the market. The technique was new to the market and certain precautions were taken so that it might not be diverted from its legitimate money market purposes. Thus the maximum amount of short and medium term securities that the Bank might buy was fixed at 500 million B francs, the total value of such bills not to exceed 200 million B francs for more than 12 consecutive months ; that of long-term Government securities was fixed at 1,000 million B francs, the securities having been issued at least two years before and quoted on the Bourse. In addition to the securities which

¹ *Sixth Annual Report of the Bank for International Settlements.*

² *Ninth Annual Report of the Bank for International Settlements* p. 121.

³ *Money and Banking*, (League of Nations), 1937-38, Vol. I, p. 86.

might be purchased by way of open market policy and in addition to those which were held by Laws of December 27, 1930, and July 19, 1932, the Bank could buy public securities to an amount corresponding to its capital surplus and amortisation accounts.¹ When the charter of the National Bank of Hungary was prolonged to 1963 in June 1938, a number of changes were made in its statutes. The most important of the new provisions was authorisation to undertake open market operations. The total amounts which could be employed for such purposes were restricted as in the case of the Belgian Bank.²

A decree dated June 17, 1938, authorised the Bank of France to undertake open market operations. "In order to influence the volume of credit and to regulate the money market," the Bank of France was authorised in addition to the operations enumerated in Art. 106 of the codification decree of December 31, 1936, to buy in the open market within the limits and under the conditions fixed by the General Council negotiable short-term public bills and private bills eligible for discount, and to re-sell without endorsement the bills previously acquired.³ In no circumstances were these operations to be carried out for the benefit of the public treasury or the issuing bodies. At the time of the currency reform of 1928, the Bank of France had already certain powers of the nature of open market operations. The Bank had been authorised by Art. 9 of the convention of June 23 between the Government and the Bank to purchase bills and short-term paper for account of foreign banks of issue.⁴ By Art 3 of the conven-

¹ *Federal Reserve Bulletin*, October 1937, pp. 1003-06.

² *Ninth Annual Report of the Bank for International Settlements*.

³ *Federal Reserve Bulletin*, August, 1938. pp. 650-65.

⁴ *Federal Reserve Bulletin*, August, 1928. pp. 573-75. ,

tion entered into the same day between the Caisse Autonome Amortissement (Autonomous Amortization Office) and the Bank, the latter had been permitted to sell in its discretion on the market and re-purchase before maturity bills of the Caisse Autonome which had been delivered to the Bank in exchange for treasury notes. From the constant performance of such operations the Bank was able to gather the experience necessary for carrying open market operations. Capital movements that affected the Paris market in recent years amply demonstrated the need of a more effective power of intervention. To that end the powers of the Bank were extended. It was also expected that the new method would reinforce its discount policy.

In several other countries, during the period under review, the adoption of open market operations was under active consideration. In Switzerland two proposals were put forward with a view to the introduction of open market operations. The Governor of the National Bank in its annual general meeting of March, 1937, urged a revision of the statutes to enable the Bank to buy bills, treasury bills and securities admitted to re-discount. The Commission for Economic Legislation also recommended the introduction of open market practice.¹

The power to undertake open market operations was granted not only to a number of older central banks which had not enjoyed such privilege before but was also provided for in the statutes of several newly created banks. In the Argentine, New Zealand, Canada and India, such powers were included in the statutes of the central banks from the beginning.

¹ Speech of the President of the National Bank to the General Meeting of Shareholders, March 12, 1938 (*Money and Banking*, 1937-38, Vol. I, p. 86 footnote).

In some of those countries the necessary conditions which have made open market operations so successful in the London and American money markets were present but in others they were not. As it has been pointed out by a recent writer, the success of open market operations depends primarily upon, first, the existence of a broad and well-organised capital market and secondly, the maintenance by commercial banks of a relatively stable cash ratio.¹ The absence of a wide and active market for government securities and the maintenance by commercial banks of an elastic cash ratio in several countries have caused such operations to be practically of limited significance. Thus we find that the Commonwealth Bank of Australia has not been able to use its open market powers because the market for government securities was rather narrow and because the commercial banks were wedded to the practice of maintaining unstable cash ratios. As we shall see in the next chapter, the same factors have also stood in the way of the Indian Reserve Bank's utilisation of open-market operations as an effective method of credit control. The development of an open market for government securities is essential for strengthening the power of the central banks to regulate credit. The Royal Commission on Australian Banking urged the establishment of an open market for treasury bills in Australia so that the Commonwealth Bank might more effectively control credit.² It is well worth while for the central banks of those countries where the money markets are either ill-organised or non-existent to explore the feasibility of adopting new and hither-

¹ A. F. W. Plumptre, *Central Banking in the British Dominions* p. 230,

² *Report of the Royal Commission on Australian Monetary and Banking System*, August, 1937, p. 234.

to untried methods of credit control rather than habitually rely on the traditional devices.

Open Market Operations in War-Time—

The trend to authorise central banks to undertake open market operations is continued in the war period. Immediately before the outbreak of the war, a new law for the National Bank of Belgium in the form of a royal decree signed by the King on August 24, 1939 extended the permissible scope of open market operations. The limit on the Bank's holdings of government securities (including short, medium and long term obligations) acquired through open market operations was raised from 1,500 million francs to a total of 5,000 million francs. A new safeguard, however, was provided against the unrestricted use of open market powers in support of government financing by requiring the Treasury to publish quarterly statements of the public debt showing separately the short, medium and long-term obligations and by requiring the Bank to report on the same dates its holdings of the three classes of securities.¹ In November 1939 the legal framework of an open market technique was created in Spain when, taking the cue from the established practice of foreign central banks, the Bank of Spain was authorised to acquire in the market for its own account or possess or transfer state and treasury securities with the sanction of the Minister of Finance.² When the Irish Central Bank was established in February 1943, it was specially empowered to buy, hold and sell securities of the Free State provided these issues had been offered for public subscription and had been quoted on the stock exchange.³ Many central

¹ *Federal Reserve Bulletin*, February, 1944.

² *Federal Reserve Bulletin*, May 1943. Report of the Bank of Spain 1936-41 pp. 405-6.

³ Sec. 7 (h) and (i) *Federal Reserve Bulletin*, February, 1943 p. 122.

banks were formally authorised to acquire Government paper in unlimited quantities in war-time. In the countries occupied by Germany, German occupation authorities had the laws of central banks amended and authorised them to buy long-term government securities.¹

In war-time the objectives of open market operations, in most of the belligerent countries were, first, to preserve a pattern of interest rates and secondly, to support the price of government securities. The technique adopted in countries with highly developed banking systems was to increase the reserve balances of the member banks so that they could subscribe to government loans. It was essential that the banks' customary or statutory cash ratio should be maintained without difficulty inspite of the large increases of their deposits as a result of their purchases of government securities. Thus the Federal Reserve Banks bought large amounts of government securities principally for the dual purpose of providing to commercial banks an adequate amount of reserves to form a basis for such purchases of government securities as were offered to them and of maintaining market stability.² In England, the Bank of England was vitally concerned in providing a basis of bank cash adequate enough to "underpin" the superstructure of bank credit which was the outcome of deficit financing from the banking system.³ The Bank undertook to purchase government securities not so much for meeting the requirements of the Government but for preventing the cash reserves of the commercial banks from being reduced as a result of the public's increased

¹ *World Economic Survey* 1942-44 p. 183.

² *Federal Reserve Bulletin*. November 1942; also *World Economic Survey* 1941-42 p. 121.

³ *The Economist*, July 25, 1942 p. 113.

demand for currency. Thus although the deposits of the British commercial banks sharply increased as a result of their purchases of government securities, their cash ratio remained remarkably stable, hovering round about the traditional level of 10%. In several other countries, however, open market operations were aimed at absorbing an excess of liquid funds on the money and capital markets. The operations of the Riksbank of Sweden and of the Central bank of the Argentine are cases in point.¹

The extent to which government securities and direct claims on government came to figure in war-time among the assets of central banks in a number of countries is strikingly illustrated in the table given below :—

Table²

Direct claims on government and government securities as % of total central bank assets.

	End of 1938	1944
Canada ..	46	89
France ..	26	81
Finland ..	10	86
Germany ..	81	96
United Kingdom ..	45	99
U. S. A. ..	17	49

The central banks' financial assistance to governments was rendered not only in the shape of purchases of government securities and direct advances but also in other forms. Movements of government deposit accounts maintained with the central banks were often a fruitful source of finance. As these balances were drawn upon and spent by the Treasury,

¹ *World Economic Survey* 1942-44 p. 184.

² *World Economic Survey* 1942-44 pp. 185.

central bank credit filtered down to the private market in the form of demand deposits or notes in circulation. In the beginning of the war in a number of countries including Belgium, France, Netherlands, Hungary, Sweden etc., a sharp reduction in government securities was to be witnessed indicating the effort of the Treasury to meet the first strain on its position through this method.¹

Speaking of open market operations in war-time, a brief reference may be made to the revolutionary change in the technique of British open market operations after the outbreak of the war. The increased scope of open market operations in war-time and the enormous expansion of deficit financing from the banking system brought out in a striking manner the shortcomings of the pre-war technique.² It was a fundamental principle of the British credit mechanism that the discount market should act as the intermediary between the central bank and the clearing banks, the latter as a result of long-established convention enjoying no right of direct access to the former. This traditional barrier between the central and clearing banks broke down in war-time. Instead of the discount market acting as a buffer between the Bank of England and the clearing banks, the latter came to be used for the first time in war-time as an intermediary through which central banking assistance could be furnished to the former. When the discount houses were unable to take the treasury bills they had tendered for in the week before, the Bank of England bought short-dated bills from the clearing banks on the understanding that they in turn would purchase longer-dated bills from the discount market. It has been, as the

¹ *Money and Banking* (League of Nations) 1939-40 p. 54.

² *The Economist*, July 25, 1942 ("War-time Changes in the Technique of Open Market Operations" I).

Economist has aptly observed, "a curious and highly significant reversal of the traditional machinery of credit control in the country."¹

In India, as elsewhere one of the most important objects of open market operations in war-time was to maintain and keep up the values of government securities. The Reserve Bank of India appears to have followed a carefully laid out plan for the purpose with a view to prepare the market for new loans that might be subsequently announced. A close study of the course of prices of some of the selected loans brings out the salient features of the Reserve Bank's operations in the open market. The 3½% paper, for instance, was being quoted up to June 2, 1942 at Rs. 91-1 and did not move up, although the prices of other loans were going up. This was due to the fact that the Reserve Bank was selling the paper at Rs. 91 until that day. The paper suddenly shot up to Rs. 91-9 on the next day because the Reserve Bank stopped selling on that day. It is significant that the price of the security did not increase further for some time in spite of a great demand for it. The reason is to be found in a renewal of sales by the Bank. Two other loans, which were similarly rigged up about that time by the Reserve Bank stopping their sales, were the 3% 1963-65 and the 3% 1951-54.²

¹ *The Economist*, August 1, 1942 ("By-passing the Market" II).

² *The Commerce*, 13 June 1942.

CHAPTER VII

THE VARIABLE RESERVE RATIO

In discussing the limited significance of open market operations in narrow markets, a suggestion was made above that central banks, in countries where money and capital markets were ill-organised or did not exist at all, should explore the possibility of utilising new and hitherto untried methods of credit control. The time has indeed come for the central banks to make a new inventory of their old arsenal of control weapons with a view to finding out whether they would be adequate for the tasks ahead or whether a bold rearmament policy was called for. It is interesting to notice in this connection a remarkable tendency for recent central banking legislation to add to the armoury of central banks an absolutely new and hitherto unused weapon of credit control in the shape of the *variable reserve ratio*. Ever since the Federal Reserve Board had suggested in their Annual Report for 1916,¹ that they should be empowered to increase in the case of an emergency the reserve ratio of the member banks, the technique has come to engage the attention of economists and bankers from time to time. Mr. H. A. S. Chandler declared in 1926 that the suggestion was so revolutionary that its adoption was out of the question.² It is Lord Keynes, who among the economists has been mainly responsible for popularising the notion by proposing in his "*Treatise on Money*" the introduction of this feature into the ideal central banking system of the future. Though revolutionary some

¹ *Annual Report of the Federal Reserve Board* for 1916 p. 28.

² *American Economic Review Supplement*, March, 1926 p. 319.

such power, he urged, should be given to the central banks. So far as the British system was concerned, he wanted the Bank of England to be given the power to vary the prescribed proportions of cash reserves to deposits to a figure between 10 and 20% for demand deposits and to a figure between 0 and 6% for time deposits.¹ A similar technique was recommended for use by the Bank of England by the Macmillan Committee who urged the view that a statutory provision of minimum cash ratios was unnecessary.² The Bank should represent to the joint-stock banks the cash percentages which it thought appropriate for the moment on the understanding that the latter should vary their cash ratios in accordance with the ideas of the central bank.

The first country to adopt this new instrument of monetary control was the United States of America. The power to change the statutory reserve requirements of member banks was for the first time conferred upon the Federal Reserve Board by the so-called Thomas Amendment included in an Act of Congress approved on May 12, 1933. It was modified and was given a permanent, instead of an emergency, status by the Banking Act of 1935. Partly as a result of open market operations and partly as a result of the continuous gold inflows, the excess reserves of the member banks had grown to unprecedented proportions. It was estimated that 50 billion dollars would be the amount of additional credit that could be created on the basis of the surplus reserves. If account were taken of further gold import and the large amounts which the Reserve Banks and the Treasury could add to the huge reserves held by the member banks, astronomical figures

¹ J. M. Keynes, *A Treatise on Money*, Vol. II, pp. 76-77. Also pp. 260-261.

² *Report of the Macmillan Committee*, para 360

would indeed be obtained.¹ In the Banking Act of 1935, it was laid down that the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, might by regulation change the requirements as to reserves to be maintained against demand or time deposits or both by member banks. But the amount of the reserves required to be maintained by any such member banks as a result of any such change should not be less than the amount of reserves required to be maintained by it on the date of enactment of the Banking Act of 1935 nor more than twice such amount. Between the summer of 1936 and the early months of 1937 the Board of Governors increased the reserve requirements of the member banks by the full amount permissible under law. In a somewhat spasmodic attempt to stimulate recovery from the recession in the latter half of 1937, reserve requirements were reduced by about one-quarter of basic requirements in April 1938.² In November 1941, they were again raised to the legal maximum.

In New Zealand when the Reserve Bank Act of November 1933 was amended by the Act of April 8, 1936, the Governor of the Reserve Bank acting with the authority of the Minister of Finance was empowered to alter the reserve ratios of trading banks from time to time as a means of maintaining effective control over the credit situation. The minimum ratios of 7% and 3% against sight and time liabilities respectively fixed by the Act of November, 1933 set the lower limit to the scope of variation.³ In Belgium the Banking

¹ Article by H. H. Preston "The Banking Act of 1935." *Journal of Political Economy*, December, 1935.

² *Federal Reserve Bulletin*, November, 1938, p. 960.

³ *The Bankers' Magazine*, April, 1939. Article by H. R. Randerson. Also *Money and Banking*, Vol. II (League of Nations), 1937-38, p. 20.

Commission which was authorised to fix cash ratios reserved the right to vary the ratios as occasion demanded.¹ In Australia the Royal Commission on Banking in their Report of August 27, 1937 recommended that the Commonwealth Bank Board should be empowered by Parliament to require, with the consent of the Treasurer all trading banks to maintain with the Commonwealth Bank a certain percentage of their deposits and also to rise and lower the percentage from time to time within the limit fixed by the consent of the Treasurer.²

It may also be noted in this connection that in Sweden the Rikstag passed an enabling Act in June, 1937, empowering the Government until February 28, 1938, to authorise the Riksbank at its request to require all joint-stock banks with own funds in excess of 5 million kronor to hold their compulsory reserve of 25% against sight liabilities only in the form of till money, balances with itself and sight claims on foreign banks and to *prescribe at will the minimum proportion of balances with itself to total reserves*.³ Provisions for flexible reserve requirements are also to be found in the case of some Latin American central banks, e.g. in Mexico and Costa Rica and to a minor extent in Ecuador. The Bank of Mexico may vary the reserve requirements of the private banks between a minimum of 5% and a maximum of 50% of their deposits.⁴ The new central banking legislation of the Republic of Guatemala is found to contain broad and flexible

¹ *Money and Banking*, Vol. I (League of Nations), 1937-38, p. 99.

² *Report of the Royal Commission on Australian Banking*, August, 1937, p. 228.

³ *Money and Banking* (League of Nations), Vol. II, 1937-38, p. 165.

⁴ Robert Triffin, "Central Banking and Monetary Management in Latin America." Art. in *Economic Problems of Latin America* Ed. by S. E. Harris p. 101, p. 110.

provisions with regard to reserve requirements of the ordinary banks and power to apply special reserve requirements against growth in aggregate deposits. The banks which have to maintain reserves amounting to not less than 10% and not more than 50% of their deposits may be required to maintain more than 50% reserves against any increase in deposits above the amount outstanding at the time such measure should be adopted.¹

Central Banking controls may be classified under three heads : quantitative, qualitative and selective. Direct quantitative controls which undertake no responsibility to guide credit into specific channels are designed to influence the volume of credit by changing the amount of available member bank reserves. The traditional instruments in this group are the discount rate policy and open market operations. The power to alter reserve ratios of commercial banks belongs to this group but in its effect on their *free* reserves, it should be sharply distinguished from the other two. While the bank rate policy and open market operations alter the volume of free reserves indirectly by influencing the total amount of reserves, the variable reserve ratio does so directly. "Whereas the other two methods are designed to bring about an actual quantitative change in *reserve holdings* and thereby in free reserves, a change in reserve requirements serves to create or destroy free reserves by a stroke of the pen."

It has been suggested that a very clear case for flexible minimum reserves will be found in countries where the scope of open market operations appears to be restricted owing to the absence of broad and active capital and money markets. A recent writer has observed that the Dominions are just the

¹ Arts. 64-68. *Federal Reserve Bulletin*, March 1946, p. 278.

place where the innovation would be most valuable.¹ In the case of India, as Dr. J. C. Sinha has clearly shown, none of the traditional weapons of credit control can be effectively wielded by the Reserve Bank.² Credit rationing is out of the question for any attempt on the part of the Bank to ration credit would make it liable to the charge of favouritism in its present position of strength and respectability. Moral suasion cannot be expected to produce any useful result in India unless the Reserve Bank were to attain the status of the Bank of England or the Federal Reserve Banks. (Discount rate policy of the Reserve Bank is blunt for all practical purposes owing to the existence of the indigenous bankers outside the fold of organised banking. Open market policy upon which habitual reliance has been placed by central banks in England and the U. S. A. would be of much too limited value on account of the absence of a wide and well-organised market for Government securities in India. Large sales cannot be effected without considering their repercussions on the credit of the Government. If the Reserve Bank of India with a view to checking incipient boom conditions were to sell government securities to any extent, the price of government stocks would decline and rates of interest rise to the possible embarrassment of the Government. It will be recalled that the Commonwealth Bank of Australia has not been able to use its powers to undertake open market operations owing to the same difficulties of a narrow market for government securities.³ Lord Keynes has rightly pointed out that the effectiveness of open market operations is dependent on the

¹ *Midland Bank's Monthly Review* May-June 1937 "Cash Reserve as a factor in Monetary Policy."

² J. C. Sinha, *Indian Currency during the Last Decade* Lecture X.

³ Report of the Royal Commission on Australian Banking, August, 1937, p. 217.

power of the central banks to have their portfolios stocked with an adequate supply of "ammunition" in the shape of open market securities available for sale.¹ Mr. Sayers has also argued that in a country where extensive open market operations by the central banks are subject to great difficulties, the mere existence of the weapon of reserve variation would add enormously to the influence of the central bank.²

Is there any case for introducing the variable reserve ratio into the central banking system of our country, as Mr. Sayers and others have suggested that there is for the British Dominions? In India, as in the Dominions of Australia, New Zealand and S. Africa, money and capital markets are narrow and ill-organised and the Reserve Bank of India's supply of "ammunition" is also inadequate. Scheduled banks again are required by law to maintain minimum reserves with the central bank. Would it not provide the Reserve Bank with an excellent opportunity to regulate the credit situation by altering the reserve ratio?

It is worth while to examine closely and carefully the question whether the variable reserve ratio would be an effective instrument of credit control here, indeed a far more effective one than in the U. S. A. In estimating the efficacy of this particular type of control, the fundamental nature of the money markets of the countries and the normal behaviour of the banks operating in them will have to be taken into consideration. In narrow markets the ordinary banks are likely to be wedded to the practice of maintaining flexible reserve ratios. The same factor, therefore, which stultifies open market operations in such markets will render the variable

¹ J. M. Keynes, *A Treatise on Money* Vol. II pp. 76-77.

² R. Sayers, *Modern Banking*, p. 295.

reserve ratio a crude and insensitive weapon of credit control.¹ This is particularly the case in Australia, New Zealand and to some extent in S. Africa. The banks there maintain highly elastic reserve ratios and possess large liquid assets in London. How variable the ratios are in the case of the Australian trading banks will be found from the figures given below. During 1925-28 the average quarterly ratio fluctuated between 18.47 and 21.24%. During 1932-35 it moved round about 15%. Between 1935-1938 it ranged between 13 and 10%.² The London funds of the Australian trading banks are given below :—³ (£000,000's)

1928	41.3	1936	23.5
1931	15.9	1937	27.2
1934	24.2	1938	25.8
1935	18.0	1939	16.6

In the circumstances they can afford to be indifferent to the position of their local cash ratios. They can indeed avoid the effect of raised reserve requirements upon their credit policies by replenishing their reserve resources with the Central Bank by selling to it a portion of their London funds. A policy of changing reserve requirements will, therefore, be inoperative so long as the banks are able to substitute their London assets by increased domestic assets with the central banks. As and when the cash ratio declines, a compensating movement of foreign assets may occur as it did in Australia in 1936-37. In India, too, the scheduled banks are not accustomed to maintain relatively stable ratios. As the

¹ A. F. W. Plumptre, *Central Banking in the British Dominions* p. 278.

² A. F. W. Plumptre, *Central Banking in the British Dominions* p. 249.

Also App. Table II, pp. 432-33

³ *International Currency Experience* (League of Nations) p. 58.

following table will show, the ratios have fluctuated within wide limits.

TABLE¹

Cash and Balances with the Reserve Bank
as percentages of total liabilities.

Average 1935-36	1936-37	1937-38	1938-39	1939-40
17.36	14.03	12.85	9.50	10.0

The ratios are sufficiently variable to be a real obstacle to the use of both open market operations and the variable reserve ratio. In India no figures of the holdings of external assets of commercial banks are published but they are believed to have been important.²

Among the British Dominions Canada presents a somewhat different case. The local money market is partly well developed and there is no need for commercial banks to maintain liquid assets in a foreign centre. The banks are accustomed to fairly stable reserve ratios which as a rule have varied between 9'5% and 11'4%. If the legal minimum was raised beyond the customary line, it would not be possible for the banks to replenish their reserves by selling London assets like their compeers in Ausralia and New Zealand. In the circumstances open market operations have been more successful there than in the other dominions and there is also a strong case for the variable reserve ratio. Those who like Mr. Sayers and the writer in the Midland Bank's Monthly Review are inclined to believe that the new device would be highly effective in narrow markets. have failed to realise the insignificance of the local cash ratios with the commercial banks, the insignificance being a result of the narrow market itself.

¹ *Report on Currency and Finance*, Reserve Bank of India 9139-40.

² *International Currency Experience* (League of Nations) 1944 p. 58.

In the case of such countries, as Mr. Plumptre has aptly suggested, a more effective weapon would be a variable minimum ratio between liquid assets as a whole and deposits rather than between cash simply and deposits.¹ The restrictive effect of increased minimum could not then be neutralised or at least delayed by transfer of foreign funds. In the Commonwealth Bank of Australia and the Reserve Banks of New Zealand and India, London assets are included as a part of their statutory minimum reserves. There is no reason why this should not be the case with the commercial banks also.

When such is likely to be the fate of the variable reserve ratio in countries with narrow and unorganised markets which have been considered to be its special habitat, what would be its significance in the wide and well-organised market of the U.S.A. where it has already been applied? The history of the operation of the variable reserve ratio in the Federal Reserve System, however, demonstrates that it has not yet developed there as a delicate and sensitive instrument of control. It has not certainly fulfilled the early expectations. A good many bankers and Reserve officials have viewed it with questioning, if not with positive disfavour and marked hostility. Three major criticisms that have been levelled against it are: it is clumsy; it is discriminatory in its effect; and it is inflexible.² First, as compared with open market operations, it lacks precision in the sense that it is inexact and uncertain as regards changes not only in the amount of reserves but also the place where these changes can be made

¹ A. F. W. Plumptre, *Central Banking in the British Dominions* pp. 270-271.

² *Quarterly Journal of Economics*, August, 1944 pp. 555-556. Art. by C. Whittlesey entitled "Reserve Requirements and the Integration of Credit Policies."

effective. The changes in reserves involve far larger sums than in the case of open market operations. The latter, again, can be applied to a relatively narrow sector. Secondly, it affects different banks differently. Banks with a large margin of excess reserves would be hardly affected while banks with small excess reserves would be hard pressed. Thirdly, it lacks flexibility in that changes in reserve requirements would not be well adjusted to meet small or localized situations of reserve stringency or superfluity. How inflexible the device is was well illustrated by the Federal Reserve System's ability to use it only to a restricted extent to relieve the reserve stringency in New York and Chicago which was the outcome of war-financing in 1942.

Apart from inflexibility, inadaptability to fine adjustment and inability to avoid undesirable disturbances and dislocations, there is another feature which sharply distinguishes the variable reserve ratio from open market operations as a control device—a feature which is significant from the point of view of central bank policy and Treasury financing, particularly in war-time. (Open market operations tend to increase or reduce the earning assets of central banks while the variable reserve ratio has no such effect.) The limit to the former is set by the extent to which central banks are prepared to part with their earning assets in combating an inflationary process. When the surplus reserves of commercial banks bear a very large proportion to the security holdings of the central banks, as it was in the case of the American member banks in 1940, the amount that could be sold in the open market without impairing the payment of customary dividends and covering expenses was hopelessly inadequate to absorb the excess reserves. No doubt as a result of war financing, the earning

assets of the Reserve Banks expanded subsequently and by 1943 became more than sufficient in relation to the amount of excess reserves which in the meantime had contracted. But there is no guarantee that the trend will be perpetuated. In any case there is a serious limitation upon open market sales policy for unlike the variable reserve ratio, it is incapable of functioning without "ammunition."

It may be recalled that one of the most serious impediments to open market operations is that large sales of government securities would depress their prices severely. This criticism is of particular force at the present time when commercial banks have come to hold large blocks of government securities. If the central bank sells long-term government bonds and the commercial banks' portfolio consists of the same type of securities, they will suffer a severe depreciation in the value of their assets. But the variable reserve ratio is not entirely free from the charge of exercising a depressing effect on the security market. When member banks are asked to increase their reserve ratios, they may be inclined to sell their holdings of long-term securities with a view to replenishing their reserves. If sales are not confined to what is just needed to meet the altered reserve requirements, which is very likely, there may be an utter collapse of the bond market.

Mr. Whittlesey in a recent paper has suggested that the integration of the two policies, open market operations and the variable reserve ratio, rather than the independent and separate use of each one, would offer an elegant solution for the principal defects attaching to each instrument individually.¹ An increase in reserve requirements, for instance, may be

¹ *Quarterly Journal of Economics*, August 1944, *op. cit.*, p. 568.

coupled, not with an open market sales policy, but with a purchase policy, supplemented as far as possible by the purchase of treasury bills. The joint application of the two policies will not be contradictory in its effect but, as the Federal Open Market Committee pointed out in 1937, may be complementary.¹ Open market purchases will be designed to maintain security prices and relieve local stringencies, in the reserves of member banks rather than increase the total volume of reserves. Member banks may tend, in such circumstances, to restrict their sales of securities to just what will be necessary to adjust their reserve position to the changed requirements. ✓

The extreme critics of the variable reserve ratio have attacked it on the ground that it would endow the central bank with power of life and death over particular member banks. But the same could be equally spoken of any other instrument of central banking policy, if it were abused. Yet no one has preferred a similar charge against any other weapon. (It may be a very powerful weapon and, if abused, may cause untold damage.) But if employed with caution and intelligence, it has possibilities. A change in the ratio may be made in such a manner as not to produce a shock which would provoke a credit panic. As Keynes himself suggested, the ratio might be varied with due notice and in small degrees.² The central bank will have to proceed very cautiously and by stages. The changes in reserve requirements may be made step by step and to avoid shock and misunderstanding announcements may be made in advance how far the bank proposed to go. Some provisions in the

¹ *Twentyfourth Annual Report of the Board of Governors* (Washington) 1938 p. 6.

² J. M. Keynes. *A Treatise on Money* Vol. II, pp. 76-77.

new Law of the Central Bank of the Republic of Guatemala are of great interest in this connection. Whenever it will be advisable to increase reserve requirements against bank deposits, the Monetary Board shall decide the reserves by a gradual and progressive manner, notifying the banks of any resolution it adopts to this effect, with reasonable anticipation of the date when it will become effective.¹ A higher differential advance may be applied against time deposits relatively to demand deposits. Again, lower differentials may be employed against the demand deposits of mofussil banks as against city banks.² If the central bank is unwilling to embarrass the least liquid banks, the increase in reserve requirements upto any ratio may be on any *future increases* of deposits.³ In times of inflation, the elimination of the vicious secondary expansion may thereby be made possible under a system of fractional reserve banking. The American Mission which recommended the setting up of a central bank for Cuba proposed the adoption of some such measure. Most of the defects of this new control device noticed above are, however, not fundamental. Some of them are purely legislative and not at all inherent in it, while the rest are faults of application arising out of the banking community's unfamiliarity with it and the authorities' inexperience of administering it.

The traditional theory underlying member bank reserve balances was that their primary function was to impart liquidity to the banks. The theory was challenged for the first time in 1931 in the Report of the Federal Reserve Board's Committee on bank reserves. The Committee denied that the

¹ Art. 66. *Federal Reserve Bulletin* March, 1946.

² Article by L. L. Watkins entitled "The Variable Reserve Ratio" in the *Journal of Political Economy* December, 1936 pp. 372-373.

³ *Economic Problems of Latin America*, Ed. by S. E. Harris, p. 110.

promotion of liquidity was the primary function of the legal reserve balances of the member banks. Indeed as we shall see later on, liquidity is seldom achieved by them. Their primary functions according to the Committee were first, to furnish resources to the Central Banks and secondly, to limit and control the rate of credit expansion. The new conception is that reserve requirements of commercial banks serve primarily not as a means of preserving their liquidity but as a medium through which a contractionist or expansionist pressure can be exerted on the credit situation. The conception has generally been accepted in the United States where, as already noted, it has become the principal instrument of monetary policy with the Federal Reserve authorities in recent years¹ and in some quarters is being regarded as "a battery of the most improved type" that a central bank can add to its arsenal.² In the British Dominions too the promotion of bank liquidity has not been considered to be an objective of legal minimum reserves. In India, however, neither the official sponsors of the Reserve Bank Bill nor the Legislature seemed to have any notion of the real purpose of the statutory balances that the scheduled banks were being asked to maintain, as is abundantly clear from the debates that took place during the passage of the Bill. It is satisfactory to notice, however, that the Reserve Bank itself has recognised in a recent official publication that the primary purpose of the statutory balances is not to impart liquidity to commercial banks but to enable the central bank to exercise some measure of control over them.³

¹ *Federal Reserve Bulletin*, November, 1938. Article entitled "The History of Reserve Requirements". p. 442.

² Goddard, *Managing Peoples' Money*, p. 442.

³ *Functions and Working of the Reserve Bank of India* (Published by the Bank) 1943 p. 40.

CHAPTER VIII

SELECTIVE INSTRUMENTS OF CREDIT CONTROL

Recent developments have blunted the edge of some of the best known traditional weapons of central banking control, qualitative as well as quantitative. The effectiveness of control has been sought to be reinforced not only by the integration of the available techniques but also by the application of absolutely new and untried devices. Bank rate policy came to be co-ordinated with open market operations in the 1920's. In the late nineteen-thirties the variable reserve ratio sprang into prominence as a new instrument. While the co-ordination of open market operations and the variable reserve ratio is being canvassed for the future, a new technique of credit control, which is neither quantitative nor qualitative, but known as the technique of "Selective Credit Control" has been slowly evolving itself, particularly in the Federal Reserve system, which has indeed become a great laboratory for testing the efficacy of various techniques. It has been made clear in the preceding discussion that the crux of the problem is to prevent a shortage of funds in the market for government securities and a superabundance of funds elsewhere. A severe decline in the prices of government securities and an impetus to inflationary forces have to be avoided at the same time. The question, therefore, is how to evolve an instrument of credit policy which would exert different degrees of pressure in selected areas—which would absorb funds from areas other than the Government securities market or which would check speculation without restricting the supply or increasing the cost of credit to trade, industry and

agriculture. In other words, what is needed is an appropriate technique of selective credit control. The concept of selective credit control owes its origin to the developments in the security market in the nineteen-twenties. It received an impetus from the experiences of the depression period when the effects of the cheap money policy initiated by the Reserve Banks in the U.S.A. for stimulating recovery were largely dissipated in the excess reserves of the member banks. A fresh impetus to this new technique was given in war-time. Regulation of margins on security transactions developed as a selective credit instrument after the speculative boom and crash of 1929-31, while regulation of consumer credit developed out of a desire to limit expenditures for non-essential purposes in war-time. As a recent writer has pointed out, owing to the lack of fluidity of money it has been possible to devise this technique of selective credit control for exerting pressure in particular areas as contradistinguished from direct quantitative and qualitative control which exert simply general pressure.¹ It has often been contended that instruments of central banking control are not at all powerful. But in the light of the preceding analysis, it becomes clear that there are conditions under which weapons of central banking control may become much too potent to be used alone. This, again, fortifies the case for a co-ordination of the various techniques available to modern central banks.

The question of fixing margin requirements as an instrument of regulation has attracted a great deal of attention in recent years in a number of countries including our own. It will be worth while to examine this question in somewhat detail, particularly in the context of the recent stock exchange boom and collapse in our country.

¹ *American Economic Review*, March, 1944 pp. 274-75.

Fixation of Margin Requirements as a regulatory instrument in the Federal Reserve System :

Over the last forty or fifty years the upswings and downswings in the stock market had always exercised a disruptive influence upon the national economy of the United States. This unstabilizing influence had never before assumed the same ugly proportions as it did in the late nineteen-twenties. The stock prices had soared upwards by 200% ; the member banks had been engaged in a mad orgy of speculation, not only by directly investing in industrial shares and bonds but also by making enormous security loans ; and the inevitable crash came in 1929. It culminated in the elimination of several thousand banks in the subsequent banking crisis of 1933. As a group of recent writers have clearly pointed out, the stock market boom was largely a product of bank credit expansion.¹ It was imperative that a recurrence of such an expansion of credit for speculative purposes should be prevented. A new instrument was called for to regulate strictly the amount of stock market credit in use. Without such stringent credit regulation, it was feared, there would be no limit except the sky to which the stock prices would shoot up, followed inevitably by a disastrous decline and a concurrent liquidation. Accordingly, the Board of Governors of the Federal Reserve System were empowered by the Securities Exchange Act of 1934 to restrict the extension of credit for the purchase and carrying of securities. Regulations introduced under this Act in October 1934 required that a certain percentage of the current market value of securities held by borrowings from brokers and security dealers should be covered by the borrower's own funds.

These "margin percentages" were governed by a sliding

¹ C. A. Philips etc., *Banking and the Business Cycle*, pp. 155-59.

scale with a view to prevent the profits realised in a rising market from being used as margins for further commitments. The margin percentage thus rose automatically from an average of 30% in October 1934 to one of 40% in January 1936 when the maximum percentage of the sliding scale was increased by the Board from 45% to 55%. In March 1936 the sliding scale was abolished and a uniform percentage of margin requirements at 55% on all loans made by brokers and dealers for purchasing or holding securities was fixed. At the same time the regulation was extended to cover security loans made by banks.¹ Margin requirements, however, were applicable to the listed securities only, the unlisted securities being left uncovered.² The method was designed to avert the same disastrous extension of credit for the purpose of speculation on the stock exchange as was witnessed in 1928-29. (It is clear that the method differed from other instruments of credit control for it affected directly the demand for, rather than the available quantity or cost, of credit.)

It was a selective control device for it exercised a restrictive influence upon speculation without at the same time limiting the supply or raising the cost of credit in the sphere of trade, industry and agriculture. When at the end of the Second World War, the credit situation became highly inflationary due to the wartime increase in the volume of purchasing power and speculative activities on the stock exchange were intensified, the margin requirements were raised by the Board to 100% on January 17, 1946 with a view to dampen these activities.³ This step had the desired effect of preventing a

¹ *Money and Banking* (League of Nations) Vol. I, 1937-38 pp. 40-41.

² *Federal Reserve Bulletin* November, 1946 p. 1234.

³ *Federal Reserve Bulletin* February 1946. p. 121.

further flow of the money borrowed from the banking system into the stock markets.) The prevailing law with regard to 100% reserve requirements was slightly modified when certain stockholders were allowed to obtain credit for certain purposes by pledging securities which for these purposes would have a loan value of 50% of their current market value. In changing the regulations the Board were convinced that the change would neither encourage speculation nor stimulate the growth of stock market credit to an appreciable extent.¹ In all other cases the 100% margin requirements remained in effect.

The employment by the Board of this new regulatory instrument in recent years has certainly helped to hold in check the unbridled speculative activities on the stock exchange, so familiar a feature of American economy in the past. This has been principally achieved by maintaining a low level of stock market credit, the outstanding amount of which stood in the neighbourhood of \$1 billion at the end of World War II as against \$3 billion at the pre-war peak of stock prices in 1937 and \$12 billion at the pre-depression peak in 1929.

As Mr. Eccles, Chairman of the Board of Governors, observed in October 1946, "One of the interesting consequences of the Board's margin requirements has been an almost uninterrupted reduction since the middle of last year in the amount of stock market credit in use, including the reduction during the period when the market was advancing which had never happened before."² The long upswing that

¹ *Federal Reserve Bulletin* December 1946, p. 1347.

² Address before the Sixteenth New England Bank Management Conference of the New England council in Boston, October 25, 1946.—*Federal Reserve Bulletin*, November 1946.

culminated in May 1946 and the subsequent downswing would undoubtedly have gone to much greater lengths, but for the Federal margin requirements. ♣

The bullish fervour that has recently characterised the Indian stock market and the enormous extent to which some of the Indian banks have entangled themselves in security loans have created a situation which appears to have the same ingredients that were well noticed in the American stock market boom and crash of 1928-29 and the subsequent banking crisis of 1933. In the circumstances the question of introducing legislation to enable the Reserve Bank of India to fix margin requirements with regard to security loans made by banks has assumed a great deal of importance at the present moment.

Margin Requirements for Indian Banks :

The wave of bullish enthusiasm which had characterised the Indian stock exchanges in war-time did not spend itself out with the termination of the hostilities. Fears of a post-war depression forecast by some eminent economists proved illusory and the slump did not materialise. Prices of securities went on rising higher and higher. A study of the market quotations of various shares in the country reveals that there was an almost fantastic rise in the quotations of most of these shares. The "Capital" stocks and shares (combined) index which had leapt from 229.7 in March 1944 to 288.8 in January 1946 shot up to 399.9 in July of the same year. The continued upward movement in the stock market was due to a variety of factors, the more important of which were the procurement and distribution of food by the Government, control over capital issues, scarcity of consumer goods, rosy prospects for Indian industries drawn by some members of the Indian

Delegation of Industrialists on their return from the U.S.A., the pursuit of a cheap money policy by the Government with frequent rumours of a reduction in the Bank rate, tax relief for Indian industries and the final abolition of the E.P.T.) It was Sir Archibald Rowland's Budget of 1946-47 which more than anything else served to drive security prices to unprecedented heights. His vigorous drive for a cheap money policy and his dramatic abolition of the E.P.T., which surpassed even the wildest imaginations of the Indian industrialists supplied the main inspiration for the stock exchange boom in India. The speculative fever was so high that even the gravest political factors failed to produce any effect on the prevailing bullishness. Throughout the dark days of suspense when the Congress and the Muslim League failed to reach a settlement and the Cabinet Mission appeared to be doomed to frustration, a curious bullish tendency was maintained throughout the market. Buoyance and optimism ruled unabated in the market and the most serious political and economic factors produced no depressing effect on the speculative exuberance. Reports of impending labour troubles at important industrial centres, a general strike demonstrating labour's achievement of an extraordinary degree of organisation, the prolonged posts and telegraphs strike which meant complete cessation of all outside support, the depressing news of the Muslim League's reversal of the previous acceptance of the Cabinet Mission's Plan—each in itself sufficient to produce a major collapse—could not arrest the bullish trends. The speculative exuberance was not damped down. As the editor of the *Statesman* put it picturesquely, the Indian investor was behaving as if there were a gold rush on.¹ The investible surplus was extraordinarily large.

¹ *The Statesman*, August 7, 1946.

The war conditions had brought about a phenomenal increase in the purchasing power of the investors and the ordinary public. The stock exchanges began to attract an army of investors who had never before taken any interest in them. The small man in India had always hoarded his savings. Gold provided a very popular method of hoarding. People with investible surpluses used to purchase land, houses and government paper or lend money at exorbitant rates of interest. In recent years gold has been maintaining a price at which even the most ignorant have looked with misgivings. The small investor has inevitably been drawn to the stock markets. Again, rent control orders in many cities and towns have served to diminish the attractiveness of investment in house property. The operations of Money Lender's Acts have curbed the activities of the mahajans. In such circumstances the lure of the stock market has proved irresistible. How large the investible surplus has been is demonstrated by the fact that although many new flotations were taking place, yet demand still more exceeded supply. The fact that the 2½% Loan of the Government was oversubscribed within a few hours on the day of issue, August 1, 1946 also suggests that the resources were far from being exhausted. In such a situation the twin pillars which continued to support the levels of stock prices were the persistent drive for cheap money on the part of the government and the widespread belief in industrial earning power on the part of the general public.

The collapse came in September 1946. The first big break in prices occurred in the Calcutta market on September 19, 1946. Prices began to topple down like a house of cards. Few could have imagined in the hectic days of July 1946 that such a sad fate would overtake the bull

market in the stock exchanges of the country. Through April and May the market had remained buoyant. In July and August, the star months as they have been called, the rise in prices of almost all the speculative counters was almost spectacular. Almost every share reached its peak level in the year—in some cases the peak levels reached were the highest in their whole history. The collapse was eventually brought about by the wild buying in the latter half of June and July, which was considerably stimulated by rumours of an impending reduction in the Bank Rate. The “Capital” index of variable yield securities which was 322.8 in April 1946 and had risen to 399.9 in July fell to 356.7 in September of the same year.¹

The Wall Street slump in the beginning of September, which was at one stage interpreted as heralding a widespread depression in American industry and as spelling the end of the seller's market throughout the world but which ultimately proved to be a mere domestic interlude, possibly produced some adverse effect on the Indian situation. The serious communal disturbances in August 1946 and large-scale labour troubles undoubtedly had their depressing effects. But the principal causes were domestic and technical,—it was the inevitable result of months of over-trading. The technical position had really grown very unsound. So long as there was a continuous upward movement in prices, the arrears in respect of deliveries were indeed welcomed. But even then the clearing arrangement had not been working well, as was evident from the Allahabad Bank's difficulty in reconciliation every week in respect of the five counters, Indian Irons, Steel Corporations, Burrakurs, South Karanpuras and Howrahs. The confusion was particularly great in respect of the two

¹ *The Capital* March 13, 1946.

counters, Sone Valley and India Steamships. These two scrips which had grown highly popular accounted for a heavy turnover and as a consequence the clearing arrangement taken over by the United Commercial Bank could be adjusted with great difficulty.¹

The violent ups and downs to which the Calcutta market was subjected during 1946 will be evident from the differences, between the highest and lowest quotations of a representative selection of shares²:

	Highest price (Date)			Lowest price (Date)		
	Rs.	A.	P.	Rs.	A.	P.
1. Bengal Coal	1,202	0	0	800	0	0
	(19-7)			(16-1)		
2. Howrah Jute	175	0	0	114	0	0
	(14-8)			(22-1)		
3. Sone Valley Cement	25	8	0	15	12	0
	(31-7)			(8-5)		
4. Indian Irons	71	12	0	48	0	0
	(31-7)			(26-11)		
5. Bishnauth Tea	65	10	0	47	10	0
	(7-8)			(20-2)		
6. Titagarh Paper	90	8	0	41	0	0
	(14-8)			(16-1)		

In London too the stock exchange has been in the grip of a bullish tendency during the past few years. Ever since 1940 the stock markets entered upon a rising trend which has been consistently maintained with intermittent disturbances. The two main pillars which have sustained

¹*The Commerce*, December 1946, p. 1105. (Annual Review Number 1946).

²*The Statesman*, January 6, 1947.

this rising trend have been, as in India, the Chancellor's drive for cheap money and prospective industrial earning power.¹ But the London prices in sharp contrast have reacted more consistently to ordinary market influences and have not been subject to the same kind of local crises which frequently overtake Indian stock exchanges.

A comparison of the indexes of security prices in the three centres, the U.S.A., the U.K. and India will reveal the hectic rises and marked recessions that took place in the last mentioned centre as against the first two :

Indexes of Security Prices (Common Stocks) ¹			
	U.S.A. (1935-39=100)	United Kingdom (1926=100)	India (1939=100)
1939	94·2	75·9	
1945	121·5	92·4	247·7
1946 January	144·8	95·2	288·8
„ February	143·3	94·9	287·1
„ March	141·8	93·8	309·1
„ April	151·6	95·2	322·8
„ May	154·3	97·6	345·3
„ June	153·2	99·5	357·7
„ July	149·6	99·2	399·9
„ August	146·4	97·6	399·2
„ September	125·4	94·6	356·7
„ October	122·3	93·0	340·6
„ November		...	320·2
„ December	...	...	316·9

The Indian Stock Market was never able to recover from the malaise that overtook it in September ; and prospects of

¹*The Economist*, June 29, 1946 p. 1053.

²*Federal Reserve Bulletin* December, 1946 p. 1431.

³Capital Stock and Share Index. *The Capital* March 13, 1947.

recovery were finally blasted by the presentation of the Hon. Mr Liaquat Ali Khan's first Budget on 28th February, 1947. The first reactions were extremely panicky and confusing. Both Bombay and Calcutta witnessed a heavy liquidation in all categories of scrips ; and the stock exchanges had to be closed. It was a budget of disillusionment. The new tax proposals which were calculated to affect industry very adversely cast a severe gloom over the whole field of it even as the previous Budget had opened up a vista of rosy prospects. The market which had been staggering as a result of a series of misfortunes since the Great Calcutta Killing now lay prostrate and gasping, smitten by this new blow from an unexpected quarter.

A large number of Indian banks, mostly non-scheduled, had made considerable advances against speculative shares and had also heavily invested in them. When the slump occurred in the Calcutta stock exchange, there was a serious banking crisis in Bengal in the cold weather of 1946. As early as May 1946, the Reserve Bank of India had issued a timely warning to all banks, scheduled and non-scheduled, against the dangerous practice of making large loans against stock exchange securities. In a circular addressed to the banks, dated 26th May 1946, the Reserve Bank had reminded them of the disastrous consequences of the practice of making large security loans which befell the American commercial banks after the stock market crash of 1929-31. It was further observed that the Bank was considering the desirability of introducing legislation for regulating margins on the lines of the American Law which was adopted to check similar speculative activities. So long as the ordinary banks were willing to accept self-imposed restrictions, the Reserve Bank would not endeavour to initiate such legislation. If the banks

had heeded the warning given by the Reserve Bank, the crisis could have been averted. To enable the Reserve Bank to consider whether any legislation was necessary or the undesirable practices could be checked with the co-operation of the banks themselves, it further sought information with regard to the advances made by the banks against stock exchange securities.

During the period from 30th November, 1945 to 24th May, 1946 the advances made by various categories of scheduled banks in India against stocks and shares showed a relatively greater expansion than other types of advances. According to the information furnished to the Reserve Bank of India by 63 reporting banks, their advances against shares increased during the period from Rs. 30.80 crores to Rs. 48.84 crores *i.e.*, by 60% in six months. In the context of the recent slump in share values in Calcutta and Bombay it is scarcely necessary to stress the desirability of exercising caution before increasing advances against shares. Another feature to be observed in this connection is that while the ratio of advances to total deposits of scheduled banks as a whole was fairly low, being about 4% on the 24th May, 1946, the ratio of advances against shares to total advances in the case of certain individual scheduled banks was unduly high. For instance, in the case of fourteen out of the above sixty-three reporting banks, the ratio of advances against shares to their total advances exceeded 25% in each case. This again emphasises the necessity of the banks' restricting their advances against shares to a reasonable proportion of their total advances or their total resources. It is also advisable that the banks should fix an absolute maximum amount of advances per share in the case of the more speculative counters. As regards margins, on 43% of their advances against shares, the reporting scheduled banks

were maintaining margins of less than 40% on 24th May, 1946. (Circular by the Reserve Bank of India dated 29 January, 1947).

Legislation on American lines empowering the Reserve Bank of India to regulate the margins which the banks may demand from their constituents before making loans against shares should be introduced in our country. But the margin requirements should not be fixed by exclusive references to the movements of share prices. The general credit situation should be the principal criterion and this in turn is an integral part of the business situation. At a time like the present, when there is an enormous volume of purchasing power in the hands of the investors and the general public, and the general credit situation is still inflationary, margin requirements should be fixed very high—as high as 100%, as they were done in the U.S.A. But when the situation will change, and there will be need to encourage the use of credit for the purchase of new securities, then the margin requirements may be lowered. That would be a time when supplies of materials and labour would be adequate enough to justify the encouragement of new issues, when employment and production would be declining and when deflationary forces would have to be offset.

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There will be some imperfections and inequities in margin requirements as a regulatory instrument, specially because the law will be restricted to covering listed securities only. But the control of listed securities greatly influences the use of credit and the market for unlisted securities. Again, legislative measures to control advances against shares by banks should be considered as part of a comprehensive scheme for reform of the Stock Exchange.

CHAPTER IX

THE CENTRAL BANK AS THE CONTROLLER OF THE VOLUME OF BANK CASH

In one important respect the Second World War may be said to have brought about a revolutionary change in monetary policy. The central bank has unobtrusively "abdicated" from the position of the controller of the volume of money. In the days before the war the public had to accept whatever volume of deposits the central bank thought fit to put in its hands. The volume of deposits in war-time came to be decided not by the central bank but by the public. As the *Economist* has observed "the real determinant of the rate of growth of deposits has been the form in which the public has elected to hold its savings."¹ The government's uncovered deficit in war-time is financed by sales of securities to four groups of buyers *viz.*, (i) internal government funds (2) central banks of foreign countries having an export surplus (3) the public and (4) the banks. "Given the amount of the Government deficit and given the amount of the country's adverse balance of overseas payments, the movement of bank deposits depends solely upon the distribution of Government's security sales to the public and the banks." This distribution is determined by the public. If the public prefers to hold a considerable portion of its saving in the liquid form of bank deposits, there would be a corresponding expansion of deposits and it is the banks which would have to lend the money to the Government. But if the public chooses to hold a large part of

¹ *The Economist*, July 7, 1945, p. 17.

its unspent incomes in less liquid form and utilises its savings in "tap" issues of Government bonds and savings certificates, there will be a relatively small increase in bank deposits. If the public is inclined to achieve liquidity by holding its saving in savings bank deposits, the same will also be true, for such deposits are direct loans to the Government.¹ It is clear, therefore, that the trend of bank deposits has been determined in war-time by the liquidity habits of the public.

This revolutionary change, however can not be strictly attributed to the War of 1939. Its beginning in England may indeed be traced to 1932 when the British Government adopted a cheap money policy. The proposition that the level of bank cash is determined by the public depends on the assumption that a cheap money policy will be continued. From the moment that policy came to be adopted, the Central Bank lost its power of sovereign control of the volume of money.² If in the post-war years, the same policy is maintained in England and other countries, the central banks will not regain their sovereignty. If the interest rates remain above the level the authorities are aiming at, they can exercise their powers of sovereignty. If interest rates have to be pushed down, more money will be required and that money will be created by them. But as soon as the rates fall to the point at which it is desired to stabilise them, the volume of money would have to be what the public desires it to be. The appropriate monetary policy to be pursued in maintaining cheap money is to see that the volume of bank credit is not less than what the public wants. Otherwise there will be frequent apprehensions of "dear money" brought about by the public's

¹ *The Economist*, July 7, 1945.

² *The Economist*, August 4, 1945, p. 161.

liquidation of securities and the resulting pressure on the gilt-edged market.

Indeed it is the need for the protection of the gilt-edged market which in effect has made the central bank surrender its autonomous control over the volume of bank cash and make it over to the public. This principle had come to be recognised even before the War of 1939 when a suitable technique was evolved by which the level of domestic deposits was sought to be stabilised during the influx of "hot money" by expanding the cash of the joint stock banks in an appropriate ratio to the increase in the borrowings of the Exchange Equalisation Account.¹

A similar technique was employed in war-time. It is clear, therefore, that the monetary technique of war is not peculiar to war and had in fact been employed long before it. That the demands of finance dictated the level of bank cash and therefore of bank deposits instead of bank cash determining the level of deposits was well known in the years prior to the outbreak of the war. In financing the uncovered deficit of the Government through the banking system, it had to be seen that the banks were able to secure the necessary reserves. But the creation of cash was dictated not by the Government demands but by the need for meeting them without abandoning cheap money. If only interest rates were not held down, a large portion of the Government's uncovered deficit could be financed by the public rather than by the banks. As the interest rates would rise, the public would be more inclined to hold assets less liquid than deposits.

So long as cheap money is the goal in the post-war economy, the task of the central bank would be to maintain

¹ *The Economist*, August 4, 1945, p. 161.

the amount of bank cash at the level required to give the public whatever volume of bank deposits it wants. Pushed to its logical conclusion, the principle requires that the public should be given not only the kind of securities it desires but also in the proportions in which it wants them. The smooth operation of a cheap money policy can not be effected by a mere rule of thumb practice of assisting the gilt-edged market whenever it is hard pressed but by the more refined technique developed during the years of the war. As a former Governor of the Bank of England put it more than a century ago, "Let the public act upon the 'circulation' and never try to make the circulation act upon the public."¹

¹ *The Economist*, August 4, 1945 p. 162

CHAPTER X

ADVANCES AND DISCOUNTS OF CENTRAL BANKS

The extension of the scope of discounts and advances is a remarkable feature of recent central banking legislation. The traditional requirements relating to eligibility have been considerably relaxed and paper which would have been frowned upon by central bankers in the years after the first Great War as lacking in security and liquidity have been declared eligible. Central banks have also been empowered to accept new types of securities as collateral for advances. But perhaps the most striking development in this connection has been the authorisation of central banks to grant direct industrial credit. The motive power behind this tendency towards the enlargement of central banking operations was supplied by a desire to help the money market to tide over temporary difficulties, the need to finance the growing expenditure of Government departments by means other than an appeal to the capital market and the necessity to provide funds to certain branches of the economic system which were not in a position to obtain them through the usual channels.¹ Treasury bills and various kinds of special bills were admitted for rediscount with the Bank of France. In pursuance of the general principles adopted by the Board of Governors of the Federal Reserve System, in the new regulations on discounts and advances of 1st October, 1937, finance paper, construction loan notes and consumers' paper were made eligible for discount. It is significant that the old provisions requiring

¹ *Money and Banking* (League of Nations) 1937-38 Vol. I, p. 83.

the use of the proceeds of eligible paper 'in the first instance' "for the purpose of producing, purchasing and carrying or working goods" find no place in the new regulations. It will undoubtedly have the effects of rendering a large amount of paper of commission merchants and finance companies eligible for discount. The recent provisions relating to the type of securities acceptable to the Federal Reserve Banks as collateral for advances appear to be more interesting. The Glass-Steagall Act of February 27, 1932 added two new sections to the Federal Reserve Act, *viz.*, Secs. 10 (a) and 10 (b) under which member banks singly or in groups of five or more could borrow from the Reserve Banks on security other than that heretofore defined as eligible for discount. Such loans were to be made at a rate at least 1% above bank rate. Previously mere eligibility would not have admitted a paper as collateral for a loan ; it would have to be in addition acceptable. The Glass Steagall Act for the first time made it possible for member banks to borrow on any sound asset,—on acceptable, if ineligible, paper and did away with the distinction between "eligibility" and "acceptability" which had been painfully built up in the years after the first World War.¹ The Act was intended to be an emergency measure to be in force for only one year and facilities under its terms could be obtained only under exceptional circumstances. With slight changes, the Act was made a permanent feature by the Banking Act of August, 23, 1935, when the emergency clause was also removed.

Ever since World War I a remarkable change has been taking place slowly and imperceptibly in the attitude of central banks regarding their relationship to business

¹ S. E. Harris, *Twenty Years of Federal Reserve Policy*, Vol. II, p. 695.

emergencies. The post-war shortage of industrial capital and the incidence of the last depression on several industries led central banks to undertake many functions which were entirely out of harmony with the traditional principles of central banking. They had to conceive it as a part of their duty to the community to preserve business from the consequences of its own blunders and even to make direct loans to industry in the event of need.¹ In several countries there arose an insistent demand that central banks should make a permanent practice of lending to industry.

The outstanding example of a central bank associating itself closely with industry and even taking a financial interest in an industrial financing company is that of the Bank of England when it organised the Bankers Industrial Development Company in 1930. In a country which is the traditional home of orthodox banking, such a departure from the recognised canons of central banking must be highly significant. It may indeed be argued that it was "an abnormal effort for an abnormal occasion"—a step of an unusual character prompted by a desire to give a helping hand in the promotion of the general welfare of the country.² But such a step would hardly have been taken by central bankers in the pre-war or in the early post-war years.

The establishment of the Bankers Industrial Development Company under the auspices of the Bank of England has not been the only instance of the association of the Central Bank of the country with industry. During the period 1922-30 the Bank of England had already become associated with a

¹P. Wills. *Theory and Practice of Central Banking with special reference to the Federal System*, Ch. III.

²Minutes of Evidence, Committee on Finance and Industry, Vol. II, pp. 294-95.

Also S. K. Basu, *Industrial Finance in India*, p. 60.

number of industrial reorganisation schemes. The Lancashire Cotton Corporation was the result of the initiative of Mr. Montagu Norman and received the direct financial support of the Bank. The armament firm of Armstrong & Co, Ltd., and the steel firm of William Beardmore & Co., Ltd., received generous assistance from the Bank in connection with their reorganisation schemes. In the years after the depression, the Bank of England is found to have associated itself with the "Credit for Industry, Ltd.," a specialist institution for financing small and middle-sized industries, through the United Dominions Trust. The Bank had become the largest share-holder of the U. D. T. by the acquisition in 1930 of 250,000 'B' shares of £1 each and it was under the aegis of the U. D. T. that the "Credit for Industry" was founded.¹

Indeed in the years after the depression this tendency for central banks to furnish industrial credit became particularly striking. In some countries provisions were even made in the statutes of central banks authorising them to make direct loans to industry. The Federal Reserve Bank Act of June 19, 1934, is perhaps the most important piece of legislation in this respect. Under its terms the Federal Reserve Banks were empowered to discount or buy from "any bank, trust company, mortgage company, credit corporation for industry or other financing institute" obligations maturing within five years entered into for the purpose of advances to commercial and industrial enterprises. The financing institution must itself advance at least 20% of the working capital or must be responsible for at least the same percentage for any loss suffered by the Federal Reserve Banks. In exceptional circumstances, the Federal Reserve Banks must make direct

¹ See the present writer's *Industrial Finance in India*, p. 49, pp. 56-57, p. 60. p. 62.

working capital advances to established private industries. The aggregate amount of credit that might be outstanding at any time was limited to the combined reserves of the Federal Reserve Banks *plus* amounts paid to the Banks by the Treasury for this purpose.¹ By December 22, 1937, the total applications received in this connection amounted to 363 million dollars of which 151 millions were approved.² The industrial advances of the Federal Reserve Banks outstanding totalled 14 million, 39 million, 25 million, 18 million and 16 million dollars at the end of 1934, 1935, 1936, 1937 and 1938 respectively.³

Under the provisions of the Act, the industrial loans of the Federal Reserve Banks were to be made upon a reasonable and sound basis. The Banks were left free to decide whether they would demand collateral security or not. As a matter of fact, few loans have been unsecured. Most of the loans have been secured by first mortgages on fixed assets, assignment of accounts receivable and chattel mortgages on machinery and equipment. The loans, as a rule are repayable in annual, semi-annual, monthly or quarterly instalments of equal or approximately equal amounts.⁴ The purpose of the loans, according to law, is to provide "working capital" but the phrase has not been defined by regulation. The interpretation has been left to the individual Banks themselves. The Banks have sought to control the disposition of the loan proceeds in various ways. One of the ways has been to provide in the loan agreements that the increase in the

¹ *Money and Banking* (League of Nations) 1937-38 Vol. II, p. 20.

² *Money and Banking* 1938-39 Vol. II, p. 188.

³ *Money and Banking* 1937-38. Vol. II, Table VIII, p. 200. Also Vol. I. fn. p. 86.

⁴ N. H. Jacoby and R. G. Saulnier, *Term Lending to Business* (National Bureau of Economic Research) pp. 84-86.

borrowers' net current assets after disbursement of the loan but leaving out the loan from current liabilities should be at least equal to the amount of the loan.¹

The Reserve Bank of New Zealand was empowered by the Amendment Act of April 8, 1936, to grant accommodation by way of overdraft to the Government and to official organisations to finance the purchase and marketing of New Zealand produce, with no defined limits to the total of Government overdrafts. These provisions were used under the Primary Produce Marketing Act of July, 1936, by virtue of which the Government became the sole exporter of dairy produce and the Reserve Bank the sole bank financing its export.² A distinct forward step towards unorthodox methods of central banking was taken when in March, 1938 a plan was put forward to involve the Reserve Bank in an ambitious scheme of Government steel production. A bill was introduced for establishing an iron and steel industry as a state monopoly and authorising the Reserve Bank to finance the project by investing in it a sum not exceeding £5 million.³ The Bank of Italy was authorised by Art. 99 of the Law of March 16, 1936 "as a special measure to carry out discounting operations during a period of three years with a view to supplying the extraordinary credit needs of certain branches of national production." From 1933 the Bank had been making advances to the Istituto per la Ricostruzione Industriale set up by the Decree of January, 1933, the second section of which took over the accounts of the Istituto di Liquidazioni and the industrial participations of credit institutions. The Istituto di Liquidazioni itself had

¹ G. K. Morris, *The Loans to Industry Programme of the Federal Reserve Bank of Philadelphia*. Quoted by Jacoby and Saulnier.

² *Money and Banking* (League of Nations) 1937-38, Vol. LL, p. 20.

³ *The Bankers' Magazine*, April, 1938, p. 621.

been established in 1926 to take over from the "Sezione autonoma del consorzio per Sorvenzioni Su valori industriale" the frozen assets of the Banco di Sconto and other institutions.¹

In war-time central banks are found to have taken a yet more important part in financing the countries' industrial war effort. The Federal Reserve Banks afford a very striking instance in this respect. By the President's Executive Order 9112 of March 26, 1942 they were authorised to arrange loans and guarantees thereof whenever they would be considered to be contributing towards the expeditious maximisation of war production. In order that they might participate more fully in the programme of war financing as contemplated by the President's Executive Order, the Regulation regarding Reserve Bank loans to industry under Sec. 13(b) (Amended) of the Federal Reserve Act, already referred to, was revised by the Board of Governors.²

A close collaboration between central banks and post-war industrial reconstruction is being contemplated in several countries. It has been proposed in the U. S. A. that to help in the provision of post-war industrial finance the scope of the provisions of Sec. 13(b) of the F. R. Act should be widened and the Reserve Banks should be authorised to guarantee financing institutions against loss on loans made to business concerns or to make commitments to purchase loans so made. Central banks in at least two countries have already been associated with the special machineries that are being set up there for financing industry in the post-war period. In Canada the Industrial Development Bank established in June 1944 is a subsidiary of the Bank of Canada which has subscribed its authorised capital of 25 million

¹ *Money and Banking* (League of Nations), 1938-39, Vol. II, p. 10v

² *Federal Reserve Bulletin*, May 1942, pp. 428-30.

dollars. The Bank of England has also subscribed to the share capital of the British I.C.F.C. and F.C.I.¹ An Industrial Finance Department of the Commonwealth Bank of Australia was established on 2nd January 1946. Its principal function will be the provision of assistance for the development and expansion of industry particularly where small undertakings are concerned for which financial accommodation is not readily available through ordinary banking or other channels. Of its initial capital of £2 million, half was transferred from the Note Issue Department and half from other funds of the Bank.*

The Reserve Bank of India, however, has been inclined to follow strictly the orthodox canons of central banking. The Bank took up a highly conservative attitude in relation to agricultural financing in its statutory report published in 1937. This attitude is based upon the traditional conception of the functions of a central bank as understood in the days before the first World War. The activities of the Reserve Bank in the sphere of agricultural financing have fallen far short of expectations and have naturally come under a fire of criticism. Caution, no doubt, is necessary but admittedly there is force in some of these criticisms. As Prof. J. P. Niyogi in a recent work has observed, the Reserve Bank has failed to distinguish between one Indian province and another and between areas in which co-operation has proved a success and in which it has not.² In its zeal to define its rôle of a strictly orthodox central banker, it has unfortunately grouped the good and bad co-operative banks together under one

¹ See the present writer's *Industrial Credit in War and Post-War Economy*, 1945. Chs. XIII and XIV.

* *Report of the Commonwealth Bank of Australia*, 1946.

² J. P. Niyogi, *The Co-operative Movement in Bengal*, p. 141

category. The most rigorous tests that the Reserve Bank may choose to apply would undoubtedly be satisfied by a large number of the banks.

When the Bank's position with regard to agricultural finance is so conservative, it is idle to expect that it will agree to "dabble" in industrial financing. It will be recalled the Bank of England played an important part in the reorganisation and rationalisation of a number of hard pressed British industries in the period of the depression that followed in the wake of the first Great War and once again in the years after the world-wide depression. But the Reserve Bank of India ever since its inception has stood scrupulously aloof from industrial financing. In war-time, again, while the Federal Reserve Banks were performing very useful functions in financing the country's war production, the steps taken by our Reserve Bank in this direction were highly inadequate.¹ The scope of its assistance was limited to such simple re-discounts as formed part of the business of central banks elsewhere even in normal times. The structure of our Central Bank, as that of the Dominions generally, has been shaped and moulded by English influence and advice. Its personnel trained in the school of British banking has closely followed the traditional precepts of the Bank of England, ignoring that the rules and laws of the Bank of England are inapplicable in countries where conditions in money and capital markets are fundamentally different. In the difficult years coming ahead of post-war industrial transition and reconstruction, the part the Reserve Bank will play will be observed with great interest. Apart from the question of financing the re-transfer of industry from a war-time to a peace-time

¹ See the present writer's *Industrial Credit in War and Post-War Economy*, 1945, pp. 22-23.

basis, it must be remembered that the tonic of the War has already developed a number of new industries and is likely to develop a few more in the near future. Reorganisation, extension and replacement of plant and machinery are also urgently called for in most of the old established industries. In the immediate post-war period the demand for industrial capital, particularly for refitting, modernising and developing, will be greater than it has ever been before. May not the Reserve Bank take, in the words of the late Governor of the Bank of England, a step of an unusual character prompted for the general welfare of the country with a view to give a helping hand? It may at least help in the establishment of a specialist institution for financing post-war industries as the Bank of England and the Reserve Bank of Canada are doing in connection with the starting of special financial machineries in their own countries. The Government of India are contemplating the establishment of an Industrial Investment Corporation for the provision of post-war industrial finance. The Reserve Bank of India may take a leading part in starting it and subscribe, like the Bank of England and the Bank of Canada, to a portion of its share capital.*

* Since the above was written, the Government of India, has introduced a Bill in the Legislative Assembly to establish the Industrial Finance Corporation of India with a view to making available more readily medium and long-term credits to industrial concerns in British India. The Institution will have a share capital of Rs. 5 crores which will be taken up by the Government of India (Rs. 1 crore), the Reserve Bank of India (Rs. 1 crore), Scheduled Banks (Rs. 2 crores) and other institutional investors (Rs. 1 crore). It is particularly gratifying to note that not only our recommendation that the Reserve Bank of India should take a financial interest in the Corporation has been accepted but also the proposed set-up has closely followed the lines suggested by us during the last ten years in various books and articles.

(See the present writer's *Industrial Finance in India and Industrial Credit in War and Post-War Economy*.)

CHAPTER XI

OBJECTIVES OF CENTRAL BANKING POLICY

An interesting development of central banking in the years after the depression is to be observed in the remarkable departure from the traditional definitions of the objectives of central banking as outlined in their statutes. Prior to World War I the statutes of central banks did not contain any definition of the general objectives of the central banking system. The primary functions of a central bank were hardly mentioned at all. There was usually a list of the operations in which the Bank could or could not engage. In the statutes of the central banks created after the first World War, definitions of objectives could no doubt be found but these objectives were rather too narrow and were limited to the regulation of the monetary circulation for the purpose of securing a stable gold value of the currency. The laws relating to the Central Banks of Bulgaria and Greece are good instances in point. The opening articles stated that the first duty of the central bank should be to ensure that the gold value of its notes remained stable and that to that end it should exercise control within the limits of its statutes over currency and credit. Statutes of central banks in countries which witnessed inflation during the War of 1914-18 and the early post-war period defined the principal objectives in similar terms. The National Bank of Roumania and the Bank of Poland furnish interesting illustrations.¹

The scope of central banking objectives has, however, been considerably broadened in more recent statutes. Regulation of the money market, promotion of the best

¹ *Money and Banking* (League of Nations), 1937-38, Vol. I. Ft. Note p. 79.

interests of the economic life of the community, monetary policy, economic stability etc. form a wide range of objectives. The Bank of Canada adopted in the preamble to the Act of 1934 its objectives as "regulating credit and currency in the best interests of the economic life of the nation, controlling and protecting the external value of the national monetary unit and mitigating by its influence fluctuations in the general level of production, trade, prices and employment so far as may be possible within the scope of monetary action."¹ The Royal Commission on Australian Monetary and Banking Systems recommended that the Commonwealth Bank's chief objective should be the reduction of fluctuations in general economic activity in Australia. The policy would be not to fix the exchange rate and to require economy in ordinary circumstances to adjust itself to that rate, but to keep the economy reasonably stable and to move the exchange rate, if necessary, as one means to that end.² Sec. 10 of the Amendment Act of 1939 defined the objectives of the Reserve Bank of New Zealand as follows :

"It shall be the general function of the Reserve Bank, within the limit of its powers, to give effect as far as may be, to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. For this purpose and to the end, that economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand, the transfer of money to and from New Zealand and the disposal of monies that are derived from the sale of any New Zealand products and for the time being are held overseas".³

¹ *Ibid* p. 80.

² Report of the Commission on Australian Monetary and Banking Systems, August, 1937, p. 234.

³ *Federal Reserve Bulletin* June 1936, p. 413.

In a statement issued in August, 1937, the Board of Governors of the Federal Reserve System stressed the inadequacy of mere price stability or exchange stability as a criterion of monetary policy. According to them the broader objective of economic stability, in the sense of the maximum sustainable utilisation of the nation's resources rather than the narrower ones of price stability and exchange stability should be the goal of public policy.¹

A reference in this connection may be made to a recent piece of central banking legislation—the organic law of the Central Bank of Guatemala. It is highly interesting in that it indicates the wide range of the objectives of modern central banking policy. The objectives have been broadly defined and domestic and international aims have been clearly distinguished. The principal object of the Bank shall be to promote the establishment and the maintenance of the monetary, exchange and credit conditions most favourable to the orderly progress of the national economy. In the domestic sphere the Bank especially must :

(1) adapt the means of payment and credit policy to the legitimate needs of the country and to the development of productive activity ; and prevent any inflationary, speculative and deflationary tendencies detrimental to the general interests ;

(2) promote the liquidity, solvency, and sound operation of the national banking system and a distribution of credit adequate to the general interests of the national economy ; and

(3) effect the necessary co-ordination between the various economic and financial activities of the State which influence the monetary and credit market, and especially between fiscal and monetary policy.

¹ *Federal Reserve Bulletin*, September, 1937, p. 828.

In the international sphere the Bank especially must (1) maintain the external value and convertibility of the currency, in conformity with the system established in the monetary law ; (2) administer the international monetary reserves of the nation and the system of international transfers, with the object of protecting the country from undue monetary pressures, and of moderating—by means of an adequate monetary, banking and credit policy—the injurious effects of seasonal, cyclical or erratic disequilibria of the balance of payments, upon money supply, credit, prices and economic activities in general ; and (3) safeguard the international economic equilibrium of the country and the competitive position of national producers in the domestic and foreign markets.¹

In recent years the question of mobility as against stability in the value of the monetary unit as constituting a suitable objective of monetary policy has attracted a great deal of attention. While some economists are inclined to maintain stability by keeping the general price index horizontal and suffering per capita incomes to move directly with changes in general productivity, others would like to do so by keeping per capita incomes horizontal and suffering the general price index to move inversely in a similar correspondence.² But it makes hardly any difference in principle whether we adopt the one or the other. Lord Keynes appears to hold the same view for in the “General Theory” he has expressed his preference sometime for the one and sometime for the other, although from the point of view of expediency he has argued the case

¹ Arts. 2-4. *Federal Reserve Bulletin*, March, 1946 p. 270.

² Art. by F. D. Graham entitled “Objectives of Monetary Policy” in the *American Economic Review*, March 1940, Supplement pp. 6-9.

in favour of keeping stable the general price index.¹ Any way, modern central banks may adopt either of these two principles as a criterion of monetary policy.

Exchange stability as a guide to monetary policy has figured so prominently in discussions of central banking objectives in India and the Dominions, that it may be interesting to investigate the real reasons for its advocacy. As it has been already noted, foreign influence and foreign advice have been responsible for shaping the structure and policies of central banking in these countries. These influential foreign advisers were internationally—shall we say imperially—minded, and they envisaged the object of the central banks in the new countries as keeping in step with the outside world. But within the countries themselves, advocates of monetary management are nationally minded and they believe that the object of central banking is to mitigate the effects of booms and depressions, especially those which have their origin abroad i.e. the objective is to break step, whenever the pace set by the outside world does not appear to be suitable.² National monetary management can go far only with flexible parities of exchange.

In the light of the above discussion, it is clear that Dr. J. C. Sinha's suggestion that the "only" objective which currency authorities should have in India is "exchange stability"³ is not only much too narrow but is also incompatible with sound national monetary management. The preamble of the Reserve Bank of India Act has used the term "monetary stability" as its objective. But it is much too

¹ J. M. Keynes, *The General Theory of Employment, Interest and Money* pp. 270-71.

² A. F. W. Plumptre, *Central Banking in the British Dominions* pp. 422-23.

³ J. C. Sinha, *Indian Currency in the Last Decade*, pp. 150-58.

wide and not very precise and may mean exchange stability, business stability or price stability. The monetary policy of our central bank should be aimed at the mitigation and, if possible, the entire elimination of cyclical and sporadic movements in the general level of prosperity. A policy of a horizontal price level with per capita income fluctuating directly with productivity or a policy of horizontal per capita income with the price level fluctuating inversely with productivity, if adopted as an objective of monetary policy, may remove some of the root causes of cyclical fluctuations. A secondary objective of monetary policy should be to avoid the wide fluctuations in the foreign exchanges which impede international trade and investment but not necessarily to be pledged to rigid parities.¹ The parities should be moved whenever the stability of the domestic economy calls for such action. The internal structure of income, wages and prices cannot be permitted to be deflated to meet the requirements of a rigid exchange rate. In these days when even the I. M. F. proposals which are avowedly aimed at maintenance of exchange stability have left room for adjustment of exchange rates for correcting disequilibrium, fixed parities must be regarded as an old and outworn dogma in monetary management. In this connection attention may be drawn to the objectives of central banking policy as outlined in the recently enacted organic law of the Bank of Guatemala referred to above. They furnish a good model for the Reserve Bank of India, being eminently suited to meet the peculiar problems that confront a largely agricultural country like India, dependent on a few exports subject to wide fluctuations of an accidental or cyclical character.

¹ Art. by Dr. H. L. Dey in *Economic Problems of Modern India*, Vol. II, pp. 244-45.

In the present times emphasis has shifted from mere price stability or exchange stability to the broader objective of employment and productive activity. The maintenance of fullest possible employment of men and resources is now the declared objective of the post-war economic system in every country. This involves the reduction of fluctuations in general economic activity. As the Australian Monetary and Banking Commission observed, since the monetary and the banking system was an integral part of the economic system, its objective would be to assist in the attainment of these ends with every means at its disposal.¹ The objective of stabilising domestic economic conditions and reducing or stopping booms and depressions can really be attained through measures acting on domestic income, investment and effective demand, and not through measures acting on the foreign balance such as exchange depreciation or import restrictions. The latter might promote employment in one country but at the cost of other countries and sooner or later will produce unfavourable repercussions on the country adopting them. But the pursuit of economic stability through national income and investment policies may be incompatible with the minimum degree of exchange stability necessary for any orderly system of international monetary relations. As a recent publication of the League of Nations has pointed out, the inevitable clash between international and domestic stability could be averted if all the countries spontaneously adopted the same objective—"a stable level of good employment" or if their policies for maintaining economic activity could be co-ordinated and synchronised.²

¹ *Report of the Royal Commission on Australian Monetary and Banking Systems*, 1937.

² *International Currency Experience* (League of Nations) 1944 p. 110.

PART TWO

WAR-TIME TRENDS IN COMMERCIAL BANKING
POST-WAR PROSPECTS

CHAPTER I

GROWTH OF BANK DEPOSITS

It has been observed that the traditional pattern of commercial bank balance-sheets was distorted beyond recognition in wartime. The sharpening outlines of this revolutionary change were dimly discernible in the cheap money phase of the post-depression period but they were brought into bold relief only during the days of the War. To have a clear perspective of the war-time trends, it will be necessary to go back to an earlier period when the very foundations of commercial banking were shaken by a convulsion hardly less violent than that of a world war. The impact of the world-wide economic depression had during 1929-34 brought about changes in the structure of the banks' assets and liabilities which were no less significant than those produced by the War of 1939-1945.

Perhaps the most outstanding trend in war-time has been the spectacular growth of deposits in the case of almost all banking systems. Deposit movements have shown a markedly uniform upward trend. But the same observation could not be made as regards the behaviour of bank deposits either in the depression or in the post-depression period. There was a remarkable lack of uniformity in the movements of deposits. During the period 1929-34, there was at first an increase in the volume of deposits (1930) but it was followed by an abrupt decline in the years immediately after. In France, Germany, Canada and the U.S.A., the deposit indices (with 1929=100) fell in 1932, and the fall was projected into the next year (1933). In most cases the recovery took

place in 1934 and was well marked in 1937. In Australia and New Zealand, where the indices had also declined, the recovery was perceptible even in 1933. The United Kingdom and India appear to be remarkable exceptions not only because the rise took place even earlier, that is, in 1932 but also because the rise was well maintained in subsequent years.

TABLE¹

Deposit Movements (1929=100)

	1932	1933	1934	1936	1937
U.S.A.	71	63	72	97	109
Germany	61	58	60	62	67
France	99	87	82	77	—
Canada	83	83	88	101	102
Australia	95	96	101	101	110
New Zealand	94	109	110	116	118
United Kingdom	108	107	108	122	123
India	106	108	111	112	113

The lack of uniformity in the movements of deposits in different countries is strikingly brought out in the table given above. It is due to the fact that different causes worked in the different countries. In some places currency policies were the determining factor; in others it was the terms of trade. In Poland, Roumania and Bulgaria, the Eastern and South Eastern debtor countries of Europe, which borrowed heavily abroad in the pre-depression years, and in which bank deposits were used as a form of investment, the contraction was particularly severe :—

¹ *Money and Banking* 1936-37 Vol. I Table III, pp. 114-117. Also *Money and Banking* 1937-38 Vol. I Table III, pp. 110-121.

TABLE¹ (1929=100)
Movements of Deposits.

	1931	1932
Bulgaria	64	56
Poland	67	59

In the first few years of the depression, the decline in the export value in many countries had not only the direct effect of deposit reduction but by depleting the gold and foreign exchange reserves of their central banks also brought about an indirect but multiple contraction of deposits.² In 1931 and 1932 currency hoarding was responsible for the reduction of deposits in the U.S.A. In France, however, the contractionist pressure exerted by the same factor on bank deposits was neutralized to a considerable extent by inflows of capital.

The situation in the war-period offers a sharp contrast to the trends in the depression period as stressed above. The continuous and persistent trend of deposits to contract during 1929-32 was definitely reversed after 1939. Deposits began to increase rapidly from 1939 onwards and the pace of expansion in the years of the second World War was altogether of a different nature from that of the earlier period. In the years after World War I, the expansion could be attributed, as it has been observed, "to the banks themselves in the performance of their traditional job—the collection of savings." But the growth during the war of 1939 was brought about by a variety of special factors. The increase in bank deposits has been the counterpart of increased national productivity, a rise in national income and growing liquidity preference of the public. The

¹ *Commercial Banks* (League of Nations) 1925-1933 p. 11. Also App. I.

² *The Eastern Economist*, September 28, 1945, p. 484.

whole motive power behind this unprecedented expansion has been provided by deficit financing and the rise in deposits is to be chiefly attributed to bank purchases of government securities. The deposits of the London clearing banks which stood at £2278 million on September 1939 rose to £2441 million in December 1939. In December 1940 the deposits rose by £359 million to £2800 million i.e. by 15%.¹ The 1943 and 1944 returns show an increase by more than £900 million in the two years.²

The tendency for deposits to expand in war-time in England, the U.S.A. and a few other countries is brought out in the tables given below :—

TABLE I³

	London Clearing Banks (In millions of £)	U.S.A. Member Banks (In millions of \$)
1939 December	2441	
1940 „	2800	56,430
1941 „	3329	61,717
1942 „	3629	78,277
1943 „	4032	92,262
1944 „	4545	1,10,271

¹ *Eleventh Annual Report of the B.I.S.* p. 152,

² *Fourteenth Annual Report of the B.I.S.* p. 187,

³ *Federal Reserve Bulletin* May 1945, p. 448 p. 512.

TABLE II¹

(In 000,000's of national currency)

	Australia (9 Trading Banks)	Canada (10 Chartered Banks)	New Zealand
1939 December	330'7	3248'6	73'2
1940 „	359'2	3209'3	79'1
1941 „	379'3	3566'5	83'0
1942 „	419'4	4202	99'7
1943 „	488'0	5049	114'1
1944 „	535'1 (August)	5458 (September)	122'0

	Germany (Big Berlin Banks)	Japan
1939 December	7,596	19,794
1940 „	10,417	24,389
1941 „	13,221	29,406
1942 „	15,409	35,738
1943 „	18,244	43,132
1944 „	—	47,229 (March)

In Sweden and Switzerland, the behaviour of bank deposits is strikingly different. In the first two years of the war, the expansion was insignificant. Indeed an actual decline took place in Sweden. In later years the increase in deposits was not as spectacular as elsewhere.

¹ *Money and Banking* (League of Nations) 1940-42 and 1942-44 Table V.

TABLE III¹

	Sweden	Switzerland	(In 000,000's of national currency)
1939 December	4401	9,872	
1940 „	4321	9,898	
1941 „	4879	10,097	
1942 „	5157	10,382	
1943 „	5762	10,826	
1944 „	6357	11,178	

The two countries have a number of features in common. Though their important overseas connections were disrupted, their exchange rates were well-maintained, fixed as they were on the dollar and their exchange position actually became very strong in the latter half of 1940. In Switzerland the returns of the banks show that whatever budget deficit there was, it was covered practically without credit expansion. The aggregate balance-sheets of the seven big banks increased by 100 million francs only and purchases of Government securities including Treasury bills were neutralized by the reduction of other assets. The National Bank's holdings of such assets also declined. Its reserve of gold and U. S. dollars increased and there was less than a 3% expansion of note issue.²

Effects upon the Banking Situation in the U.S.A. :

The enormous growth of deposits had a remarkable effect on the banking situation in one country—the U.S.A. In a sense it might be said to have brought about the termination of one episode in the history of American banking and to have introduced a new era. Deposits expanding along with currency under the influence of the country's war effort

¹ *Ibid.*

² *Twelfth Annual Report of the B.I.S.P.* 160.

caused a reversal of the almost uninterrupted tendency of the excess reserves to grow over a long period.¹ The reversal was spectacular: the familiar problem of ever expanding excess reserves being suddenly changed into one of dwindling reserves. Monetary authorities who had in the post-depression years been concerned in formulating devices to check the growth of surplus reserves constituting a potential threat of inflation now became busy in adopting measures designed to offset the various factors which were tending to reduce the surplus reserves. On June 29, 1940 the excess reserves (monthly average) of member banks stood at \$6,696 million but in four years they dwindled by 84% to \$1081 on June 29, 1944. An enormous banking expansion resulting from the acquisition of Government securities to finance the war effort had taken place in the country. In the process of this expansion by far the greater proportion of the huge excess reserves held prior to the war was used up. Roughly speaking excess reserves are reduced by \$1 million for every increase of \$5 million in deposits, and currency expansion causes a dollar for dollar reduction. Demand deposits of member banks had increased during December, 1940 to December, 1944 by \$45,945 million while currency in circulation had expanded during the period from \$8732 million to \$25,207 million.² As a consequence a great deal of the excess reserves was no longer "excess" but constituted merely "required" reserves.

This decline in the excess reserve position of the American banks to the low level indicated above evidences undoubtedly a major landmark in the country's banking development of

¹ *The Economist*, (Banking Supplement), September 19, 1942 pp. 8-9.

² *Federal Reserve Bulletin*. June 1945, 578 p. 580.

almost the same importance as the fall in the Federal Reserve ratio itself.

War-time changes in the composition of the balance sheets of the banks in India have been no less striking. The growth in the volume of deposits during the war, thanks to the increase in the note issue, has been as spectacular as in any other banking system. The total demand and time liabilities of the Indian scheduled banks rose from Rs. 245,68 lakhs in 1939-40 to Rs. 778,92 lakhs in 1944-45 i.e. by Rs. 533,24 lakhs.

TABLE¹ [In lakhs of Rs.]

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
245,68	268,84	318,96	410,49	599,41	778,92
(11,09)*	(11,86)*	(15,46)*			

The index of the total time and demand liabilities of scheduled banks (with 1938-39=100) rose from 103.3 in 1939-40 to 327.5 in 1944-45.

Deposit Indices² (1938-39=100)

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
103.3	110.0	134.1	179.6	252.0	327.5

In sharp contrast to this war-time increase, deposits during the pre-war years 1935-36 to 1938-39 rose from Rs. 220,56 lakhs to Rs. 237,83 lakhs i.e., by Rs. 17,27 lakhs only, the index having risen from 92'7 to 100'0.

Composition of Deposits :

A striking feature of the war-time expansion of bank deposits in almost all countries has been a preponderant growth

¹ *Report on Currency and Finance*, Reserve Bank of India, 1944-45, Statement XXV. * Burma figure.

² *Ibid.*, Statement XXVI.

of demand and sight relative to time and savings deposits. In the case of the English clearing banks, in the three and half years upto December 1943, more than 80% of the rise in their deposits was in current accounts and less than 20% was in time deposits.¹ In the U. S. A. during 1940-1944 the demand deposits of member banks rose from \$33,829 million to \$79,774 million i.e., by 135.8% while time deposits increased from \$12,178 million to \$19,259 i.e., by 58.1% only.²

This war-time shift from time and savings deposits to current and sight deposits is almost universal and is to be found in a marked degree in Australia, Canada and New Zealand.

TABLE³

Commercial Banks (000,000 Currency Units)						
1939	1940	1941	1942	1943	1944	Percentage Increase
AUSTRALIA.						
Current and Sight						
120.2	138.5	157.8	193.7	258.7	320.2	166.6
Time or Fixed—						
205.6	216.4	211.7	197.1	201.2	222.5	8.3
CANADA.						
Current and Sight—						
1033.6	1163.4	1435.5	1984.0	2446.8	..	136.8
Time or Fixed—						
1741.1	1641.3	1669.0	1673.2	1947.8	..	11.8
NEW ZEALAND.						
Current and Sight—						
38.4	46.6	53.7	61.5	77.1	85.1	124
Time or Fixed—						
29.9	31.3	28.6	28.4	28.6	29.7	0

¹ *Fourteenth Annual Report of the B.I.S.* p. 187.

² Calculated from the data given in the *Fed. Reserve Bulletin*, May 1945 p. 448.

³ *Money and Banking*, (League of Nations) 1942-44 p. 83, p. 95, and p. 156.

In the case of the scheduled banks in India the demand liabilities rose from Rs. 139,65 lakhs in 1939-40 to Rs. 584,80 lakhs in 1944-45 *i.e.*, by 318.7% while time liabilities during the same period increased from Rs. 106,03 lakhs to Rs. 194,12 lakhs *i.e.*, by 83% only. The detailed figures for the various years are given below:—

INDIAN SCHEDULED BANKS (In Lakhs of Rupees)					
1939-40,	1940-41,	1941-42,	1942-43,	1943-44,	1944-45.
Demand liabilities—					
139,65	163,90	211,35	306,28	456,63	584,80
Time liabilities—					
106,03	104,94	107,61	104,21	142,78	194,12

The continuous and considerable increase of demand liabilities over the whole period is the most striking feature of the table given above. During the first three years there was hardly any increase of time deposits. A definite trend towards their increase is to be witnessed from 1943-44, but the demand liabilities continued to increase at an equal or higher rate till October 1943 when the highest proportion of demand to time liabilities was reached at 77.3. Thereafter the proportion declined and for the first time the rate of increase of time liabilities became greater than that of demand liabilities. In March 1945¹ the index of the latter rose from 358 to 465 while that of the former from 127 to 204. These trends indicate a preference of time over demand liabilities for the first time since the outbreak of the war and a reduction of the growth of the inflationary potential. It appears that public confidence in the general economic situation was being gradually restored and a measure of financial and economic stability was being attained.¹

¹ *Report on Currency and Finance, Reserve Bank of India, 1944-45, p. 77.*

DEPOSIT INDICES.¹ (1938-39=100)

Indian Scheduled Banks.

	1939-40,	1940-41,	1941-42,	1942-43,	1943-44,	1944-45.
Time	98.3	97.3	99.8	96.6	132.4	180.0
Demand	107.4	126.1	162.6	235.6	351.3	449.9

These war time trends may be contrasted with the situation as it stood in the years after World War I and the Depression. In marked contrast with the trends during World War II it is found that during 1920-29 while both demand and time deposits had grown, the latter increased at a definitely higher rate than the former. There was an unmistakable tendency towards a relative increase of time as against demand deposits in a large number of countries including the U. S. A., France, Canada and Japan. Figures showing the deposit indices of commercial banks in some of these countries are available and they clearly indicate this general post-war tendency of deposits to shift from sight or short term to savings or longer term. Thus in the case of the national banks in the U. S. A. the index for current accounts rose from 100 in 1931 to 136 in 1929 while that for savings and time deposits increased from 100 to 1086 during the same period. The table given below strikingly illustrates the tendency:

DEPOSIT INDICES²

	1913	1920	1925	1926	1927	1928	1929
U. S. A.—							
Current Accounts . .	100	74	115	121	124	139	135
Time and Savings							
Deposits . . .	100	279	811	882	976	1,068	1,086

¹ *Ibid.*, Statement XXVI, p. 124.

² *Memorandum on Commercial Banks* (1913-29) League of Nations, Table V. pp. 30-32.

	1913	1920	1925	1926	1927	1928	1929
FRANCE.—							
Current Accounts ..	100	70	72	80	97	119	124
Time and Savings							
Deposits ..	100	43	32	36	41	66	129

Tables exhibiting the same tendency may be given for other countries as well. Tendencies towards increase of demand as against time deposits are witnessed in Norway and a few other countries but they are not real but merely formal exceptions. Dr. Muranjan has argued in a recent publication that the war-time change in the composition of deposits is the continuation of a process initiated during the first World War.¹ In the light of the foregoing discussion his contention does not appear to be quite correct. This change in the composition of bank deposits was further accompanied by a parallel movement in the composition of credits. The credits came to shift from shorter to longer accounts. This parallelism was a remarkable phenomenon and appeared to reflect a change in the very status of commercial banks.²

This trend for current accounts to decline in importance relatively to time deposits was projected into the first years of the depression. In 1931 and 1932 there was a remarkable shift of deposits from current to time and savings accounts in many countries including the U. S. A., British Dominions, Switzerland and Sweden.

¹ S. K. Muranjan, *Economics of Post-War India* (Second Ed.) p. 123.

² *Memorandum on Commercial Banks* (1925-33) League of Nations 1934, p. 7. Also the writer's *Industrial Finance in India* Ch. IV.

As percentages of Total Deposits.¹

	1929	1931	1932	1933	1936
U. K.					
Current Accounts ..	54.0	50.6	50.7	53.0	56.0
Time Deposits ..	46.0	49.4	49.3	47.0	44.0
(London Clearing Banks)					
U. S. A.					
Current Accounts ..	55.2	53.2	53.3	57.9	65.9
Time Deposits ..	44.8	46.8	46.7	42.1	34.1
(All Banks)					
Canada					
Current Accounts ..	30.4	29.5	24.0	25.1	27.7
Time Deposits ..	69.6	70.5	76.0	74.9	72.3
Australia					
Current Accounts ..	33.3	31.1	32.1	33.8	35.0
Time Deposits ..	66.7	68.9	67.9	66.2	62.8 (1935)
Sweden					
Current Accounts ..	18.9	17.2	17.6	18.6	23.3
Time Deposits ..	81.1	82.8	82.4	81.4	76.7
Switzerland					
Current Accounts ..	27.5	15.5	17.2	17.4	13.8 (1935)
Time Deposits ..	72.5	84.5	82.8	82.6	86.2 (1935)

The decline in demand deposits came to be arrested in a number of countries when the central banks there began to make large advances to their Governments to help them to meet budgetary deficits and also to increase the cash basis of the commercial banks. Instances in point are furnished by Mexico, Colombia, Ecuador, Chile and Brazil. In the case of

¹*Money and Banking* 1936-37. Vol. I. (League of Nations) Table XI pp. 150-51.

India also demand deposits appear to have recovered in 1932 as will be evident from the figures given below:—

As Percentages of Total Deposits.

	1929	1932
India (Six Banks) Current Accounts ..	32.0	42.0
Time Deposits ..	68.0	58.0

The remarkable shift noted above from time and savings accounts to demand deposits in the years of the War of 1939-45 was due to a variety of factors having different degrees of importance in different countries. As the *World Economic Survey* has pointed out, these factors were chiefly the overall preference for liquidity, low and declining interest paid on time deposits and a change in monetary turn-over. Conditions of uncertainty and emergency generated by the war tended to increase the liquidity preference of the people who showed a marked desire to hold their savings in the form of current accounts. War-time controls and rationing brought about a significant alteration in the monetary turn-over.¹ The volume of currency and deposits created by the banking system and spent by the Government increased, on the one hand, but physical controls, on the other hand, restricted the quantity of goods available for private consumption. In the circumstances idle funds tended inevitably to accumulate in the hands of the consumers and business men. In other words, the “velocity of circulation” declined. The spread of barter meant a further decline in the average velocity of circulation.

¹ *World Economic Survey* (1939-41) and (1941-42) League of Nations Geneva p. 99 and p. 131.

CHAPTER II.

CASH AND LIQUIDITY RATIOS.

On the assets as on the liabilities side, the distribution of banking assets underwent equally remarkable changes in war-time. Such changes, however, were not uniform in all banking systems and even showed marked divergences from one year to another in the same system. First, as regards the cash or primary ratio, the London clearing banks showed a practically unchanged cash ratio, not only during war-time when deposits sharply increased but also as compared with the normal pre-war period. The ratio has fluctuated between 10 and 11% as was usual in pre-war time.

TABLE¹

Cash Ratio (Cash Reserve as % of Deposits.)							
	1939	1941	1942	1943	1944		
					Mar.	Sept.	Dec.
London Clearing Banks	11	11	11	10	11	10	11

As the *Economist* has pointed out, such steady cash ratios over the war period indicate that the authorities took good care to create as much bank cash as would underpin the structure of credit on which the banks' participation in deficit financing depended. But apart from cash, there has been a revolutionary change in the composition of the quick assets, which make up the total used for calculating the liquidity ratio of the banks; and this liquidity ratio has steadily mounted

¹ *Fourteenth Annual Report of the B. I. S.*, p. 186.

to a height unknown and unattained in the pre-war days. In the pre-war period a liquidity ratio of 30% was considered to be quite a desirable mean. At the beginning of the war the ratio stood at 28.5%. Over the next four years it rose to a peak of 47.9% in September 1943. Although the cash ratio remained practically unchanged since 1939, the percentage of short loans to deposits fell from 6 to 7% in 1939 to nearly 4% in 1943 and that of bills discounted to deposits declined from a pre-war range of 12—16% to 6%. The make-up of the quick assets has been revolutionized by the emergence of a new item—the Treasury Deposit Receipts which came to represent 26% of deposits in September 1943 and closed the gap shown by the above figures.¹ Ever since their debut in July 1940, the centre of the stage of “quick assets” has been dominated by them. In 1944 the secondary reserve ratio (proportion of total liquid assets other than cash reserves to deposits) rose to 40%, two-thirds of which were made up by the T. D. Rs., and the total liquidity ratio (including cash) shot up to 50%, a degree of liquidity quite unprecedented in the banking history of England.² The percentage of T. D. Rs. to deposits rose still higher subsequently and in July 1945 stood at 41.4%.³

Now that the Treasury Deposit Receipts were tending in war-time to occupy the front rank in the structure of the liquid assets, it is worth while to examine their claim to be included as a component of true quick assets. They are non-negotiable and they can be encashed only under certain conditions, that is, they cannot be encashed to relieve a strained cash position. These two features qualify their character.

¹ *The Economist, Banking Supplement*, November 13, 1943 p. 1.

² *Fourteenth Annual Report of the B. I. S.* p. 187.

³ *The Economist*, August 31, 1946, p. 341.

They can no doubt be discounted with the Bank of England but this provision is not considered to be practical politics by the banks. Above all, the freedom of the banks to adjust their cash position by arranging their T. D. R. maturities is limited, for the initiative in determining the payments made week by week in new T. D. Rs. is beyond their power.

The peculiar feature of by far the most preponderant component of their liquid assets has obliged the banks to increase the liquid character of their other quick assets. They are increasingly growing concerned about the currency of the bills they will purchase and are as a rule inclined to take only bills of particularly short currency. In the pre-war days or even in the early war years bills having run a week or so at the discount houses could be resold to the clearing banks ; while in the present times bills must have run at least four or six weeks before they would be attractive to them. Bills would not be bought to-day if they had on the average to run more than six weeks, not to speak of the twelve weeks which was the practice until 1941. The new technique of open market operations which has cut at the very roots of the traditional relationship between the Bank of England and the clearing banks is a factor distinctly favouring the holding of short-dated papers by the banks. When the Bank of England to-day buys bills from the clearing banks in the course of its open market operations to ease the credit situation, it usually prefers very short-dated papers. By holding short-dated papers itself, the banking system fits well into the framework of the central bank's new technique of open market operations. Apart from the fact that the T. D. Rs. have grown to be the most important component of the bank's liquid assets, its existence furnishes a ready means for controlling the supply

of loanable funds and in the post-war years is likely to provide the authorities with a new instrument of monetary control.¹

In sharp contrast with the maintenance of steady cash ratios by the London clearing and Canadian banks,* commercial banks in a large number of countries have worked with mounting cash ratios in war-time. In Australia and New Zealand, cash ratios tended to increase during 1938-44.,

TABLE²

(Cash as % of Total Deposits)

	1938	1940	1941	1942	1943	1944
Australia						
(9 Banks)	11.0	11.9	12.5	25.1	33.7	41.1
New Zealand						
(Trading Banks)	15.4	23.1	21.7	23.2	23.1	31.1

The same trend of steadily increasing cash reserves is to be witnessed in the case of the Indian scheduled banks. Their total cash and balances with the Reserve Bank of India rose from Rs. 24,51 lakhs in 1939-40 to Rs. 116,56 lakhs in 1944-45. During the same period the proportion of this item to total deposits increased from 9.98% to 14.96% and the index of the percentage (with 1938-39=100) shot up from 105.1 to 157.5. The following table gives the details from year to year.

¹ *The Bankers' Magazine*, September 1945 p. 173.

	1939	1940	1941	1942	1943	1944
* Canada—	10.2	11.1	10.9	10.4	11.9	12.9

² *Money and Banking* 1942-44 (League of Nations) 1945 Table VI, p. 65.

TABLE¹
Scheduled Banks in India

Percentage of cash and balances with the Reserve Bank to total deposits.					
1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
9.98	16.66	14.58	16.73	14.05	14.96
Index of the percentage of cash and balances with the Reserve Bank to total deposits (1938-39=100).					
105.1	175.4	153.5	176.1	147.9	157.5

Between cash and balances with the Reserve Bank, the latter have increased at a far quicker pace than the former which has been less erratic and more steady.

As regards the liquidity ratio of Indian banks, the composition of the quick assets which make up the total for calculating it is different from that in England. Such assets in England are made up of cash, short loans and bills discounted. In war-time, it may be recalled, to these has been added a new item, the T. D. Rs., which is occupying the front rank in the list of such assets. In the Continent law has given such assets a varied form and these include gold, government securities etc. In the absence of any law upto the present the practice of Indian bankers has been to regard "the total of cash, free investments and bills" as constituting the liquid assets.² From this point of view the liquidity ratio i.e., the ratio of cash plus investments to deposits in the case of the Indian scheduled banks was fairly high on the outbreak of the war and rose during the course of it. From 56% in 1939

¹ Statements XXV and XXVI. *Report on Currency and Finance*, Reserve Bank of India 1944-45.

² Statement of Mr. G. D. Birla, Chairman, United Commercial Bank Ltd., to the Share-holders Meeting, 28th March 1945.

it increased to 75.3% in 1943.¹ The ratio of liquid assets to deposits in the case of some individual scheduled banks stands to-day at the level of 66% and even 83%.*

The cash ratios in the U. S. A., however, rapidly declined and, as already indicated, gave rise to new problems.

TABLE²

	1939	1940	1941	1942	1943	1944
Member Banks—	31.6	33.2	26.9	21.3	17.4	15.7

The post-depression trends in commercial bank cash ratios may be contrasted in this connection with the war-time trends. While in England as a result of custom and tradition, cash ratios were maintained at a stable level, in other countries variations in the reserve ratios of commercial banks were fairly wide. As a result of gold influxes the commercial banks' cash ratio increased in the Netherlands from 7.2% in 1930 to 19.0% in 1932. In the United States also the same factor of a gold influx served to increase member banks' cash reserves in excess of the legal minima from \$866 million in January 1943 to \$3,084 million in January 1936. The cash ratio rose from 21.2% in 1926 to 23.3% in 1934, 27.2% in 1935 and 28.0% in 1936.³

The rules of the gold standard game required that changes in central banks' international assets were to be reinforced by concurrent changes in the domestic assets. As a matter of fact, however, in the inter-war period, it will be recalled, central banks' domestic and international assets frequently moved in the opposite rather than in the same direction. It is

¹ *Statistical Tables relating to Banks in India and Burma* 1942-43.

* Cf. The United Commercial Bank (85.2%) and the Bengal Central Bank Ltd.

² *Money and Banking* (League of Nations) 1942-44 Table VI, p. 67.

³ See *Money and Banking* 1938-39 Vol. I, (League of Nations) App. Table IX.

interesting to notice further that in many instances movements in central banks' international reserves were offset in the sphere of commercial rather than that of central banking, through the accumulation of idle cash reserves by commercial banks. If the central banks' domestic assets were very small at the beginning, automatic neutralization could not occur within the central bank but only outside it.¹ It is clear the central bank in such cases could offset an increase in its international reserve only upto the amount of the domestic assets held by it. Once these assets began to sink to or near zero, its power to neutralize disappeared. Such automatic offsetting in the sphere of commercial banking took place in the Netherlands, Switzerland and Sweden where the domestic assets of the central banks were small to start with. The cash reserves of the commercial banks were increased as a result of influxes of gold but no additional credit structure was built upon the increasing cash reserves and the gold inflows were practically offset.

¹ *International Currency Experience* (League of Nations) 1944 pp. 70-71, pp. 80-81.

CHAPTER III

ADVANCES AND BILLS DISCOUNTED.

In the war-time structure of assets, the reflex of the movements in cash and balances with the central bank was for a long time represented by advances and bills discounted. The latter in many countries exhibited, for a long time after the war, converse movements to those of the former. It is in respect of these that the most significant changes have taken place. As the *Eastern Economist* has observed, "It is difficult to disentangle the effects of seasonal changes, ups and downs of business, panicky war developments and recent control measures from the basic trend. Nevertheless the distinct trend of the declining importance of advances is discernible".¹ The advances of the London clearing banks dropped from £1,002 million in December 1939 to £754 million in December 1944. It will be found from the table given below that there has been a progressive decline in them.²

London Clearing Banks (In millions of £)					
1939	1940	1941	1942	1943	1944
1,002	906	807	773	743	754

Slight recoveries could be witnessed in some parts of the years (as in the first quarter of 1942) but they were really temporary deviations from an unmistakable downward trend since the outbreak of the war. This decline in advances affected all categories of loans and overdrafts.

In India the behaviour of "advances and discounts" in war-time has to be carefully examined. In line with Great

¹ *The Eastern Economist*, January 14, 1944 p. 43.

² *Fourteenth Annual Report of the B.I.S.* 1943-44 p. 186.

Britain these no doubt dropped but the fall was neither so great nor so continuous and persistent as there. A close examination of the behaviour of advances and discounts in the Indian bank portfolio will reveal that it was highly irregular, panicky war developments and seasonal factors influencing it to a considerable extent. Immediately after the outbreak of the war, trade and commodity prices experienced boom conditions and the volume of advances registered a sharp rise from Rs. 109·3 crores in August 1939 to Rs. 163·10 crores in March 1940. There was a persistent decline thereafter with the exception of the first three months of 1941. By September 1942 the downward trend of advances and discounts was over and the process of recovery definitely began thereafter. From the total of Rs. 80·12 crores in that month, the figure rose to Rs. 287·72 crores in March 1945, an increase of 259%. Their percentage to total deposits increased from 19·6 to 34·9%. The annual averages were, however, 23·8% in 1942-43, 27% in 1943-44 and 30·2% in 1944-45. Although the level of bank advances has remarkably shot up during 1942-45, it is not reflected in the rising percentage to deposits for the concurrent increase in the latter has been remarkably heavy. But it sharply contrasts with the pre-war (1938-39) percentage of 50·8%.¹

In seeking an explanation of the irregular, almost erratic, behaviour of this item in the balance-sheets of Indian banks, it should be remembered that the country's war-effort reached its peak from 1943 onwards. The inflationary marking up of commodity prices was no doubt an important factor but the principal factor making for the remarkable growth must have been the rising tempo of economic activity since 1943.² The

¹ *Report on Currency and Finance*, Reserve Bank of India, 1944-45, p. 77.

² *The Eastern Economist*, December 21, 1945 p. 909.

decline in imports, shrinkage in the free sector of international trade, progress payments made by the government to war contractors and the general liquidity of business were, as elsewhere, the factors which had tended to reduce the demand for banking accommodation and had brought about the fall in advances. As the influence of these factors waned and the pace of economic activity began to increase, advances inevitably rose¹. There were also other factors contributing to the rise. Speculative elements must have been responsible to some extent. Further, the compulsory deposits under the E. P. T. and the "pay as you earn" scheme of income tax may be presumed to have induced business concerns to seek accommodation from their banks which they would not otherwise have done.²

The figures for the scheduled banks' total amounts of advances and discounts and their percentages to total time and demand liabilities are given in the table below³ :—

	Total Advances and Discounts. [In Lakhs of Rs.]	Percentages to total liabilities.
1938-39	120,71	50·75
1939-40	131,14	53·38
1940-41	125,97	46·86
1941-42	125,13	39·23
1942-43	97,86	23·83
1943-44	161,73	26·98
1944-45	235,38	30·22

The declining trend of advances and discounts is also noticeable in Australia and Canada.

¹ *Report on Currency and Finance*, Reserve Bank of India 1945-46, p. 93.

² *Journal of the Indian Institute of Bankers*, January, 1945 p. 25.

³ *Report on Currency and Finance*, Reserve Bank of India 1944-45, Statement XXV p. 123.

	Discounts and Advances as % of Liabilities. ¹				
	1936	1940	1941	1942	1943
Canadian Banks (11 Banks)	31·3	32·8	33·0	26·4	22·9
Australian Banks (5 Banks)	68·1	63·2	59·8	51·0	42·5

Decline in Bank Commercial Financing :

The causes of this declining importance of advances and discounts are to be found in England as in India in the loss of overseas markets and war-time restrictions on exports and imports, the reduction in the stocks of many manufactured and semi-manufactured commodities, the growth of liquid assets in the hands of individuals and business firms which have led to repayments of bank loans and on the industries' part to self-financing, elimination of middlemen, the concentration of trade and industry and the direct financing of war industries by the governments themselves.² In India, however, nowhere did we witness the same concentration of industries, limitation of civilian trade and the elimination of private finance from all Government controlled internal and external markets as was familiar in England. The system of "progress payments" under which war industries were financially assisted by the state was not developed to the same extent in this country as in England. In such circumstances the fall in advances was not so steep here as in England. Not only was the drop much less severe but the declining trend, as it has already been noted, was reversed from 1942. It must also be pointed out that though their percentage to deposits registered a marked decline, their absolute volume did not, only with the important exception of

¹ *The Economist, Banking Supplement*, October 28, 1944 p. 9.

² *The Statist, Banking and Commercial Review* (Half-yearly) August 29, 1942 pp. 1-3.

a period of 10 months from April 1942 to February 1943, fall below the pre-war level of Rs. 120 crores in 1938-1939. For the greater part of the period it was above this level and towards the close of the war it was distinctly upward.¹ Any way, the position of advances in the balance-sheets of the banks has definitely shifted and this is highly significant.

The altered position of "advances" in the bank balance-sheets had the immediate effect of producing a loss of revenue in the shape of interest and commission which the banks had to face at the time of an enormous rise in general expenses. But this decline in revenue was more than compensated for by additional income from the holdings of Government securities. In fact, as we shall presently see, there has been a remarkable switch-over from advances to Government securities in the structure of banking assets. This replacement of advances by securities reflects a fundamental change in the traditional function of commercial banks. Their business appears to be no longer the financing of trade and industry but the running of a specialised investment trust in all manner of Government securities.² They have been transformed from providers of short-time capital to industry to providers of long-term funds for Government.

The decline in the private sectors of business activity and the increasing intrusion of the state into the field of trade and industry in war-time strikingly illustrate the reduced importance of commercial-banking in Germany. In 1942 commercial bills and loans represented one-third of their assets as against 60 to 70% before the war. Advances on goods which accounted for 1/5 of the assets in 1929 practically sank to nil. Self-financ-

¹ *The Eastern Economist* January 14, 1945 p. 44.

² *The Statist, Banking and Commercial Review* (Half-yearly) August 29, 1943 ("Bank Advances and Industry"), p. 1.

ing and the provision of credits by various Government departments to the war industries rendered them independent of bank assistance and the importance of commercial banks as a traditional source of industrial credit greatly declined. The field of activity remaining open to the banks came to be increasingly narrowed and the banks were compelled to initiate a "concentration" movement and explore other convenient and profitable avenues of activity.¹ The closing down of 2600 branches in 1943 as part of the drive for rationalisation and the programme of geographical expansion aiming at "Germanisation" of business firms in occupied and annexed territories were some of the notable steps taken in self-defence. Dr. Funk, announcing certain changes in the method of financing armament orders in a speech in 1942, had raised hopes in the minds of German bankers that they would be able to resume their business of industrial credits on a normal scale.² But these hopes remained unfulfilled still in 1943 although the practice of advance payments on munitions contracts had been suspended a year earlier.³

This downward movement in advances has been a feature which has been viewed with profound disquiet, if not alarm, by bankers every where—in England, Germany, the U. S. A. and India. It has, as the *Economist* has remarked, cut at the very root of a type of asset which is at once most remunerative and most representative of genuine commercial banking tradition.⁴ Bankers are looking forward to the day when they will be able to hold more of these assets.

¹ *The Statist*, July 4, 1942 pp. 492—493 ("War-time Banking in Germany").

² *The Statist, International Banking Section*, November 28, 1942 ("Banking in Germany") p. 8.

³ *The Statist, International Banking Section*, November 27, 1943, p. 14 ("German Banks in Total War").

⁴ *The Economist, Banking Supplement*, September 20, 1941.

CHAPTER IV

BANKS AND WAR FINANCING

The part played by the commercial and central banks in war financing depends on the extent of the preference of the public to hold bank deposits or bank notes. In countries like England, the U. S. A. and the British Dominions, where the public holds a large amount of its money in the shape of bank deposits, the commercial banks have furnished a greater proportion of the loans and the direct share of the central banks in war financing has been relatively small. In the highly developed banking systems of England and the U. S. A., the increase in the central banks' holding of Government securities, while meeting the demands for currency in circulation, was mainly designed to furnish an adequate cash basis to the commercial banks so that they might themselves take up the Government loans. Open market operations and reduction of reserve requirements were the devices adopted to provide the increased reserves to the commercial banks. In countries where the public is accustomed to hold large sums of money in the form of cash rather than of bank deposits, the central banks have taken up a greater proportion of the Government debt than the commercial banks. Bulgaria and Finland are cases in point, where the relatively larger participation of central banks in the financing of Government loans was reflected in the increase in note issues as compared to bank deposits.¹

Generally speaking, the commercial banks in most of the belligerent countries were called upon to take up not only that

¹ *World Economic Survey 1941-42* (League of Nations) pp. 120-121.

portion of the short-dated Government securities which the central banks had not taken up but also to purchase large blocks of long-dated securities issued by the Governments. As the central banks were exempted in many instances from the existing legal limits on the amount of their direct loans to Governments, the commercial banks in their turn in some countries came to be statutorily obliged to maintain a portion of their assets in Government securities.

Detailed figures for the distribution of the ownership of government debt are not available for all countries. But for a number of countries it is possible to estimate approximately the proportion of the Government debt absorbed by the banking system and even its distribution between the central and commercial banks. In the case of almost all countries involved in the war the percentage of Government debt absorbed by the banking system has been fairly large. But this percentage has differed from country to country, being the largest in Japan and being larger in the case of the U.S.A. than in that of the U.K. Within the banking system itself again, the percentage of absorption by central banks has been greater in some countries than in others.

The war-time balance-sheets of commercial banks almost universally reveal the domination of the gilt-edged security in the composition of their assets. Ever since the outbreak of the war there has been a progressive increase in their "investments" of which the bulk has consisted of treasury bills and Government securities. By 1941 British banking had passed a significant milestone in that the combined total of "loans and advances" came to be exceeded¹ by "investments" for the first time in that year.¹ By the end of 1944 the London clearing banks' hold-

¹ *The Economist, Banking Supplement*, September 20, 1941.

ings of Government securities (Treasury Bills, Treasury Deposit Receipts and Government long-term securities) totalled £2979 million and in the course of 1945 they passed the £3000 million limit, constituting more than 66% of the balance-sheet totals of the banks. More than two thirds of the banks' deposits thus came to be covered by Government securities and the banks may be said to have partaken of the character of investment institutions in some respects.¹ In 1941 the trading banks of New Zealand increased their holdings of Government securities by 31%, the commercial banks of South Africa by 36% and those of the Argentine and Sweden by 100%. In the same year in Germany the holdings of treasury bonds and Reich loans constituted 56% of the total assets of the five leading commercial banks as against 28% in 1939.²

In the following table will be found the progressive rise in the holdings of Government securities among the "Investments" of commercial banks of a number of countries.

TABLE³

Commercial Banks' Investments.

(In 000,000's of National Currency.)

	United Kingdom (Joint Stock Banks in England and Wales.)	Canada.	New Zea- land.	South Africa
1939 Govt. Securities	548	1524	15.2	52.1
Other „	85	122	0.3	4.2
1940 Govt. Securities	712	1432	17.5	73.5
Other „	82	99	0.5	3.7

¹ *Fourteenth Annual Report of the B.I.S.* (1943-44) p. 187. Also *Fifteenth Report* p. 69.

² *World Economic Survey*, 1941-42 p. 124.

³ *Money and Banking*, (League of Nations) 1942-44 Table V.

	United Kingdom (Joint Stock Banks in England and Wales.)	Canada	New Zea- land.	South Africa
1941 Govt. Securities	949	1670	23'0	100'5
Other „	949	87	0'8	3'7
1942 Govt. Securities	1072	2210	34'3	124'8
Other „	69	83	1'0	4'1
1943 Govt. Securities	1102	2867	36'1	186'4
Other „	72	72	1'9	4'7
1944 Govt. Securities	—	3372	36'1	194'0
Other „	—	2'5	78	4'1

The case of the American banks' participation in war finance calls for a somewhat detailed investigation. There has been an undercurrent of feeling that the Treasury was highly successful in its war loan drives and had to depend relatively little on the commercial banks. The banks' participation in war finance appears to be small and the Treasury's policy, it has been urged, has been remarkably non-inflationary. But a careful examination of the position will at once reveal the large extent of deficit financing undertaken by the banks in the country. Between October 1942 and December 1943 the holdings of U. S. Government securities on the part of commercial banks increased by \$25,000 million ; and those of the weekly Reporting Member Banks increased another \$2,646 million by February 1944. Besides, large loans were granted for purchasing and carrying securities, mostly issues of the Federal Government. During October 1942 and February 1944 such loans granted by the Reporting Member Banks increased by nearly \$2,000 million. During these sixteen months the commercial banks' financing of the Federal deficit

amounted to more than \$30 billion which exceeded 33% of the increase in debt. The banks, though appearing to have participated only to a small extent, actually participated very largely. The explanation is to be found in the fact that although the greater part of the debt was primarily distributed to non-bank buyers, there took place a "leakage" or secondary distribution of the larger proportion of it to the banks themselves.¹ In the process of acquiring such a large part of Government debt, the commercial banks involved themselves in providing the general public with large amounts of cash. As a consequence, the reserve position of the commercial banks became considerably strained and the excess reserve declined sharply. The table given below shows the American member banks' holdings of Government securities.

TABLE²

Member Banks' Investments. \$ (000,000's)		
1939	Government	. . 17,020
	Other	. . 2,950
1940	Government	. . 18,836
	Other	. . 2,970
1941	Government	. . 22,629
	Other	. . 2,871
1942	Government	. . 40,511
	Other	. . 2,654
1943	Government	. . 55,677
	Other	. . 2,294

¹ *The Economist*, April 22, 1944 ("American Banks and War-Financing") p. 539.

² *Money and Banking* (League of Nations) 1942-44 p. 205.

More than 70% of the total earning assets of the commercial banks in the U. S. A. came to be made up of Government securities in 1944. About the same percentage of the earning assets was composed of such securities in Germany, France and Belgium. In Canada it was 50%¹ As regards the percentage of Government debt absorbed between the central and commercial banks, the Japanese commercial banks easily top the list with an absorption of 82.2%. Next come the commercial banks in the U. S. A., Canada and the United Kingdom with 33.9%, 16.9% and 16.2% respectively. The central banks in all these countries took up a far smaller proportion of the Government debt as will be evident from the following figures.²

	Percentage of Govt. debt absorbed by the Banking System.	Percentage of debt absorbed by Central Banks.	Percentage of debt absorbed by Commercial Banks.
U. K. (1939-44)	24.7	8.5	16.2
U. S. A. (1939-44)	41.8	7.9	33.9
Canada (1939-44)	31.2	14.3	16.9
Japan (1939-43)	97.6	15.4	82.2
Finland (1939-43)	59.2	38.6	20.6

It will be seen that the participation of the British banking system in the absorption of Government debt was smaller than that of the American. It implies that large amounts of Government loans must have been taken up by non-bank investors. As a result of the liquidation of foreign assets, private investors in Great Britain re-invested the proceeds of the sale of the foreign securities in domestic government securities. Moreover, the central banks in sterling area

¹ *World Economic Survey* 1942-44 p. 186.

² *Ibid.*, p. 179.

countries including India took up large proportions of British treasury bills.

The same pattern of behaviour of bank investments is to be witnessed in India.

TABLE¹

Investments of Commercial Banks (In lakhs of Rupees).

	1938	1941	1942	1943
Imperial Bank of India	43,72	64,39	116,41	130,20
Other Scheduled Banks	39,63	58,52	101,77	164,25
Non-Scheduled Banks	3,41	5,80	8,32	10,04
(with capital and reserves of Rs. 1 lakh and over).				
Total	86,76	128,71	226,50	304,49

But although the total investments increased, the ratio of investments to deposits declined from 59·3% in 1942 to 53% in 1943, as a result mainly of the sharp rise in deposits :—

Ratio of Investments to Deposits.²

	1938	1941	1942	1943
For all the above three types of Banks.	46·1	49·9	59·3	53·0

Owing to the lack of banking statistics neither the holdings of Government securities by commercial banks nor the percentage share of the central and commercial banks in Government debt participation can be ascertained. The scheduled banks have been known to be keeping 60% of their assets in Government securities and the Imperial Bank, some-

¹ *Statistical Tables relating to Banks in India and Burma*, 1942 and 1943 p. VIII.

² *Ibid.*

times an even higher percentage.* According to the Governor of the Reserve Bank of India, this may be taken as a measure of the Indian banking system's contribution to the defence loans. The success of Government borrowing particularly by means of treasury bills at cheap rates has been due to a great extent to subscriptions of the banks. As regards the Reserve Bank of India's share in the ownership of Government debt in war-time, it will be found that "direct claims on Government and Government securities" held by it increased from Rs. 416 lakhs in 1938 to Rs. 1,234 lakhs in December 1942 and to Rs. 1,753 lakhs in March 1943. But in sharp contrast to central banks elsewhere the percentage of this item to total assets is not only very small but has also tended to decline since December 1943. The position is strikingly brought out in the table given below.¹

	(a) Table Direct claims on Govt. and Govt. Securities	(b) Total Assets.	(a) as% of (b)
	Rs. (000,000's)	Rs. (000,000's)	
December 1938	416	2,248	18·5
„ 1939	487	2,801	17·0
„ 1940	497	3,205	15·4
„ 1941	415	4,205	9·8
„ 1942	1,234	6,665	18·5
March 1943	1,753	7,514	23·3
December 1943	586	9,826	6·0
September 1944	589	12,721	4·6

But the conclusion should not be hastily drawn from the

* According to balance-sheet as at 31st December 1945 the Imperial Bank's holding of Government securities amounted to 57% of total assets; that of the Punjab National Bank was 50%.

¹ *Money and Banking* (League of Nations) 1942-44 Table II p. 39.

figures given above that the Reserve Bank of India played a very small part in war financing. The picture will not be complete unless account were taken of the Bank's holding of sterling securities. The truth is that the Bank has played an important part in financing not only the war expenditure of the Government of India but also that of the British and Allied Governments. Direct loans to the British Government have been camouflaged as foreign assets of the Reserve Bank. A sharp increase in these assets has taken place in war-time. A considerable portion of this increase represents in effect British Government debt held by the Reserve Bank. The total sterling assets of the Issue and Banking Departments amounted to £1066.85 million or Rs. 1432.46 crores on the 30th June 1945. These are maintained in cash and investments in short-term British Government securities renewed from time to time.¹ It is clear that a large amount of the sterling assets—the portion that is maintained in cash—is an interest free loan.

The following table reveals the enormous growth of sterling assets during 1938-1944.²

Sterling Securities plus Balances held abroad.		Rs. (000,000's)
1938 December	608	
1939 „	1,130	
1940 „	1,987	
1941 „	2,892	
1942 „	4,758	
1943 „	8,554	
1944 September	11,390	

¹ *Report of the Eleventh Annual General Meeting of Shareholders*, August 1945. Reserve Bank of India p. 26.

² *Money and Banking*, (League of Nations), 1942-44, Table II; p. 39.

The almost universal increase in commercial bank investments just noticed is in sharp contrast with the decline in bank advances discussed before. The two are not, however, entirely unrelated to each other. Traditional banking practice would lead one to suppose that the fall in advances was the cause of the rise in investments. As a recent writer has suggested, "In view of the necessarily limited scope for advances, banks have had to expand their investment portfolios".¹ But this is hardly correct. The banks purchased investments not because they could not employ their money in any other manner. But they did so as the outcome of the decision of public policy that they must buy investments, first, to bring down interest rates to a low level, and thereafter, to furnish funds for the Government's war expenditure. According to the *Economist*, it would be more correct to say that the rise in investments was the cause of the falling demand for advances.²

This dominance of Government securities in commercial bank balance-sheets in most of the countries has far reaching implications. It is clear that the banking systems in England, the U. S. A. and elsewhere have been geared to the financing of the war machine in a manner unknown before. As it has been well observed, the banking systems have become complaisant, if not willing, instruments of improvident Government war finance.³ The banks, as we have seen above, invested an overwhelming proportion of their resources in Government securities of one kind or another. This portends the perpetuation of the banking system's subordination to the

¹ *Journal of the Indian Institute of Bankers*, January 1945 p. 25.

² *The Economist*, February 14, 1942, (The Banks in Transition III), p. 228.

³ *The Statist*, International Banking Section, November 25, 1944, p. 8.

financial policies of the Government. It must also be recognised that medium-dated Government loans, even when they are protected by maturity dates, do not constitute the ideal counterpart to short-term deposits of commercial banks. Especially when the investments dominate more than 31% of the deposits in England and 50% in India, a situation is created which gives cause for concern, if not alarm. As the *Economist* has pointed out, from the point of view of the nation as a whole or of that of their customers, there should be a saturation point to the banks' holdings of even medium-dated government stock.¹ In such circumstances it is satisfactory to note the reduced rate of increase of the banks' investments in England in 1943, as compared with 1942. In India also there appears to be a tendency on the part of the banking system in recent years not to accumulate more of the gilt-edged, if not to reduce its holdings actually.²

As the banks to-day are in the grip of the gilt-edged, they must be vitally concerned in keeping down the rate of interest and preserving the value of their capital assets. A rise in the rate of interest will mean a decline in the prices of Government securities and severe capital depreciation for the banks. This is a powerful factor which must induce future Governments to keep money rates down and gilt-edged securities up. The portfolio of investments of most Indian banks is well stocked with medium-dated Government stock. In the case of individual banks the proportion of such investment is said to be 20 and even 25% of their capital and deposits. But as we have already seen, such securities are not as liquid as they may appear. Even the floating debt of the

¹ *The Economist*, Banking Supplement, November 13, 1943, p. 3.

² Art. entitled "War-time Banking" in the *Eastern Economist*, December 21, 1945, p. 909.

Government is a liquid form of asset only in the legal sense. Moreover, a number of banks are known to hold long-dated or undated securities in such high proportions as 30 and even 35%. This practice should have been discouraged, as Dr. Muranjan has suggested, by compelling the banks as in the U. S. A. to purchase only dated loans in war-time.¹

¹ S. K. Muranjan, *Economics of Post-war India* p. 17.

PART TWO

WAR-TIME TRENDS IN COMMERCIAL BANKING
POST-WAR PROSPECTS

CHAPTER I

GROWTH OF BANK DEPOSITS

It has been observed that the traditional pattern of commercial bank balance-sheets was distorted beyond recognition in wartime. The sharpening outlines of this revolutionary change were dimly discernible in the cheap money phase of the post-depression period but they were brought into bold relief only during the days of the War. To have a clear perspective of the war-time trends, it will be necessary to go back to an earlier period when the very foundations of commercial banking were shaken by a convulsion hardly less violent than that of a world war. The impact of the world-wide economic depression had during 1929-34 brought about changes in the structure of the banks' assets and liabilities which were no less significant than those produced by the War of 1939-1945.

Perhaps the most outstanding trend in war-time has been the spectacular growth of deposits in the case of almost all banking systems. Deposit movements have shown a markedly uniform upward trend. But the same observation could not be made as regards the behaviour of bank deposits either in the depression or in the post-depression period. There was a remarkable lack of uniformity in the movements of deposits. During the period 1929-34, there was at first an increase in the volume of deposits (1930) but it was followed by an abrupt decline in the years immediately after. In France, Germany, Canada and the U.S.A., the deposit indices (with 1929=100) fell in 1932, and the fall was projected into the next year (1933). In most cases the recovery took

place in 1934 and was well marked in 1937. In Australia and New Zealand, where the indices had also declined, the recovery was perceptible even in 1933. The United Kingdom and India appear to be remarkable exceptions not only because the rise took place even earlier, that is, in 1932 but also because the rise was well maintained in subsequent years.

TABLE¹
Deposit Movements (1929=100)

	1932	1933	1934	1936	1937
U.S.A.	71	63	72	97	109
Germany	61	58	60	62	67
France	99	87	82	77	—
Canada	83	83	88	101	102
Australia	95	96	101	101	110
New Zealand	94	109	110	116	118
United Kingdom	108	107	108	122	123
India	106	108	111	112	113

The lack of uniformity in the movements of deposits in different countries is strikingly brought out in the table given above. It is due to the fact that different causes worked in the different countries. In some places currency policies were the determining factor; in others it was the terms of trade. In Poland, Roumania and Bulgaria, the Eastern and South Eastern debtor countries of Europe, which borrowed heavily abroad in the pre-depression years, and in which bank deposits were used as a form of investment, the contraction was particularly severe :—

¹ *Money and Banking* 1936-37 Vol. I Table III, pp. 114-117. Also *Money and Banking* 1937-38 Vol. I Table III, pp. 110-121.

TABLE¹ (1929=100)
Movements of Deposits.

	1931	1932
Bulgaria	64	56
Poland	67	59

In the first few years of the depression, the decline in the export value in many countries had not only the direct effect of deposit reduction but by depleting the gold and foreign exchange reserves of their central banks also brought about an indirect but multiple contraction of deposits.² In 1931 and 1932 currency hoarding was responsible for the reduction of deposits in the U.S.A. In France, however, the contractionist pressure exerted by the same factor on bank deposits was neutralized to a considerable extent by inflows of capital.

The situation in the war-period offers a sharp contrast to the trends in the depression period as stressed above. The continuous and persistent trend of deposits to contract during 1929-32 was definitely reversed after 1939. Deposits began to increase rapidly from 1939 onwards and the pace of expansion in the years of the second World War was altogether of a different nature from that of the earlier period. In the years after World War I, the expansion could be attributed, as it has been observed, "to the banks themselves in the performance of their traditional job—the collection of savings." But the growth during the war of 1939 was brought about by a variety of special factors. The increase in bank deposits has been the counterpart of increased national productivity, a rise in national income and growing liquidity preference of the public. The

¹ *Commercial Banks* (League of Nations) 1925-1933 p. 11. Also App. I.

² *The Eastern Economist*, September 28, 1945, p. 484.

whole motive power behind this unprecedented expansion has been provided by deficit financing and the rise in deposits is to be chiefly attributed to bank purchases of government securities. The deposits of the London clearing banks which stood at £2278 million on September 1939 rose to £2441 million in December 1939. In December 1940 the deposits rose by £359 million to £2800 million i.e. by 15%.¹ The 1943 and 1944 returns show an increase by more than £900 million in the two years.²

The tendency for deposits to expand in war-time in England, the U.S.A. and a few other countries is brought out in the tables given below :—

TABLE I³

	London Clearing Banks (In millions of £)	U.S.A. Member Banks (In millions of \$)
1939 December	2441	
1940 „	2800	56,430
1941 „	3329	61,717
1942 „	3629	78,277
1943 „	4032	92,262
1944 „	4545	1,10,271

¹ *Eleventh Annual Report of the B.I.S.* p. 152,

² *Fourteenth Annual Report of the B.I.S.* p. 187,

³ *Federal Reserve Bulletin* May 1945, p. 448 p. 512.

TABLE II¹

(In 000,000's of national currency)			
	Australia	Canada	New Zealand
	(9 Trading Banks)	(10 Chartered Banks)	
1939 December	330'7	3248'6	73'2
1940 „	359'2	3209'3	79'1
1941 „	379'3	3566'5	83'0
1942 „	419'4	4202	99'7
1943 „	488'0	5049	114'1
1944 „	535'1	5458	122'0
	(August)	(September)	

	Germany	Japan
	(Big Berlin Banks)	
1939 December	7,596	19,794
1940 „	10,417	24,389
1941 „	13,221	29,406
1942 „	15,409	35,738
1943 „	18,244	43,132
1944 „	—	47,229 (March)

In Sweden and Switzerland, the behaviour of bank deposits is strikingly different. In the first two years of the war, the expansion was insignificant. Indeed an actual decline took place in Sweden. In later years the increase in deposits was not as spectacular as elsewhere.

¹ *Money and Banking* (League of Nations) 1940-42 and 1942-44 Table V.

TABLE III¹

	Sweden	Switzerland	(In 000,000's of national currency)
1939 December	4401	9,872	
1940 „	4321	9,898	
1941 „	4879	10,097	
1942 „	5157	10,382	
1943 „	5762	10,826	
1944 „	6357	11,178	

The two countries have a number of features in common. Though their important overseas connections were disrupted, their exchange rates were well-maintained, fixed as they were on the dollar and their exchange position actually became very strong in the latter half of 1940. In Switzerland the returns of the banks show that whatever budget deficit there was, it was covered practically without credit expansion. The aggregate balance-sheets of the seven big banks increased by 100 million francs only and purchases of Government securities including Treasury bills were neutralized by the reduction of other assets. The National Bank's holdings of such assets also declined. Its reserve of gold and U. S. dollars increased and there was less than a 3% expansion of note issue.²

Effects upon the Banking Situation in the U.S.A. :

The enormous growth of deposits had a remarkable effect on the banking situation in one country—the U.S.A. In a sense it might be said to have brought about the termination of one episode in the history of American banking and to have introduced a new era. Deposits expanding along with currency under the influence of the country's war effort

¹ *Ibid.*

² *Twelfth Annual Report of the B.I.S.P.* 160.

caused a reversal of the almost uninterrupted tendency of the excess reserves to grow over a long period.¹ The reversal was spectacular: the familiar problem of ever expanding excess reserves being suddenly changed into one of dwindling reserves. Monetary authorities who had in the post-depression years been concerned in formulating devices to check the growth of surplus reserves constituting a potential threat of inflation now became busy in adopting measures designed to offset the various factors which were tending to reduce the surplus reserves. On June 29, 1940 the excess reserves (monthly average) of member banks stood at \$6,696 million but in four years they dwindled by 84% to \$1081 on June 29, 1944. An enormous banking expansion resulting from the acquisition of Government securities to finance the war effort had taken place in the country. In the process of this expansion by far the greater proportion of the huge excess reserves held prior to the war was used up. Roughly speaking excess reserves are reduced by \$1 million for every increase of \$5 million in deposits, and currency expansion causes a dollar for dollar reduction. Demand deposits of member banks had increased during December, 1940 to December, 1944 by \$45,945 million while currency in circulation had expanded during the period from \$8732 million to \$25,207 million.² As a consequence a great deal of the excess reserves was no longer "excess" but constituted merely "required" reserves.

This decline in the excess reserve position of the American banks to the low level indicated above evidences undoubtedly a major landmark in the country's banking development of

¹ *The Economist*, (Banking Supplement), September 19, 1942 pp. 8-9.

² *Federal Reserve Bulletin*. June 1945, 578 p. 580.

almost the same importance as the fall in the Federal Reserve ratio itself.

War-time changes in the composition of the balance sheets of the banks in India have been no less striking. The growth in the volume of deposits during the war, thanks to the increase in the note issue, has been as spectacular as in any other banking system. The total demand and time liabilities of the Indian scheduled banks rose from Rs. 245,68 lakhs in 1939-40 to Rs. 778,92 lakhs in 1944-45 i.e. by Rs. 533,24 lakhs.

TABLE¹ [In lakhs of Rs.]

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
245,68	268,84	318,96	410,49	599,41	778,92
(11,09)*	(11,86)*	(15,46)*			

The index of the total time and demand liabilities of scheduled banks (with 1938-39=100) rose from 103.3 in 1939-40 to 327.5 in 1944-45.

Deposit Indices² (1938-39=100)

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
103.3	110.0	134.1	179.6	252.0	327.5

In sharp contrast to this war-time increase, deposits during the pre-war years 1935-36 to 1938-39 rose from Rs. 220,56 lakhs to Rs. 237,83 lakhs i.e., by Rs. 17,27 lakhs only, the index having risen from 92'7 to 100'0.

Composition of Deposits :

A striking feature of the war-time expansion of bank deposits in almost all countries has been a preponderant growth

¹ *Report on Currency and Finance*, Reserve Bank of India, 1944-45, Statement XXV. * Burma figure.

² *Ibid.*, Statement XXVI.

of demand and sight relative to time and savings deposits. In the case of the English clearing banks, in the three and half years upto December 1943, more than 80% of the rise in their deposits was in current accounts and less than 20% was in time deposits.¹ In the U. S. A. during 1940-1944 the demand deposits of member banks rose from \$33,829 million to \$79,774 million i.e., by 135.8% while time deposits increased from \$12,178 million to \$19,259 i.e., by 58.1% only.²

This war-time shift from time and savings deposits to current and sight deposits is almost universal and is to be found in a marked degree in Australia, Canada and New Zealand.

TABLE³

Commercial Banks (000,000 Currency Units)						
1939	1940	1941	1942	1943	1944	Percentage Increase
AUSTRALIA.						
Current and Sight						
120.2	138.5	157.8	193.7	258.7	320.2	166.6
Time or Fixed—						
205.6	216.4	211.7	197.1	201.2	222.5	8.3
CANADA.						
Current and Sight—						
1033.6	1163.4	1435.5	1984.0	2446.8	..	136.8
Time or Fixed—						
1741.1	1641.3	1669.0	1673.2	1947.8	..	11.8
NEW ZEALAND.						
Current and Sight—						
38.4	46.6	53.7	61.5	77.1	85.1	124
Time or Fixed—						
29.9	31.3	28.6	28.4	28.6	29.7	0

¹ *Fourteenth Annual Report of the B.I.S.* p. 187.

² Calculated from the data given in the *Fed. Reserve Bulletin*, May 1945 p. 448.

³ *Money and Banking*, (League of Nations) 1942-44 p. 83, p. 95, and p. 156.

In the case of the scheduled banks in India the demand liabilities rose from Rs. 139,65 lakhs in 1939-40 to Rs. 584,80 lakhs in 1944-45 *i.e.*, by 318.7% while time liabilities during the same period increased from Rs. 106,03 lakhs to Rs. 194,12 lakhs *i.e.*, by 83% only. The detailed figures for the various years are given below:—

INDIAN SCHEDULED BANKS (In Lakhs of Rupees)					
1939-40,	1940-41,	1941-42,	1942-43,	1943-44,	1944-45.
Demand liabilities—					
139,65	163,90	211,35	306,28	456,63	584,80
Time liabilities—					
106,03	104,94	107,61	104,21	142,78	194,12

The continuous and considerable increase of demand liabilities over the whole period is the most striking feature of the table given above. During the first three years there was hardly any increase of time deposits. A definite trend towards their increase is to be witnessed from 1943-44, but the demand liabilities continued to increase at an equal or higher rate till October 1943 when the highest proportion of demand to time liabilities was reached at 77.3. Thereafter the proportion declined and for the first time the rate of increase of time liabilities became greater than that of demand liabilities. In March 1945¹ the index of the latter rose from 358 to 465 while that of the former from 127 to 204. These trends indicate a preference of time over demand liabilities for the first time since the outbreak of the war and a reduction of the growth of the inflationary potential. It appears that public confidence in the general economic situation was being gradually restored and a measure of financial and economic stability was being attained.¹

¹ *Report on Currency and Finance, Reserve Bank of India, 1944-45, p. 77.*

DEPOSIT INDICES.¹ (1938-39=100)

Indian Scheduled Banks.

	1939-40,	1940-41,	1941-42,	1942-43,	1943-44,	1944-45.
Time	98.3	97.3	99.8	96.6	132.4	180.0
Demand	107.4	126.1	162.6	235.6	351.3	449.9

These war time trends may be contrasted with the situation as it stood in the years after World War I and the Depression. In marked contrast with the trends during World War II it is found that during 1920-29 while both demand and time deposits had grown, the latter increased at a definitely higher rate than the former. There was an unmistakable tendency towards a relative increase of time as against demand deposits in a large number of countries including the U. S. A., France, Canada and Japan. Figures showing the deposit indices of commercial banks in some of these countries are available and they clearly indicate this general post-war tendency of deposits to shift from sight or short term to savings or longer term. Thus in the case of the national banks in the U. S. A. the index for current accounts rose from 100 in 1931 to 136 in 1929 while that for savings and time deposits increased from 100 to 1086 during the same period. The table given below strikingly illustrates the tendency:

DEPOSIT INDICES²

	1913	1920	1925	1926	1927	1928	1929
U. S. A.—							
Current Accounts . .	100	74	115	121	124	139	135
Time and Savings Deposits . . .	100	279	811	882	976	1,068	1,086

¹ *Ibid.*, Statement XXVI, p. 124.

² *Memorandum on Commercial Banks* (1913-29) League of Nations, Table V. pp. 30-32.

	1913	1920	1925	1926	1927	1928	1929
FRANCE.—							
Current Accounts ..	100	70	72	80	97	119	124
Time and Savings							
Deposits ..	100	43	32	36	41	66	129

Tables exhibiting the same tendency may be given for other countries as well. Tendencies towards increase of demand as against time deposits are witnessed in Norway and a few other countries but they are not real but merely formal exceptions. Dr. Muranjan has argued in a recent publication that the war-time change in the composition of deposits is the continuation of a process initiated during the first World War.¹ In the light of the foregoing discussion his contention does not appear to be quite correct. This change in the composition of bank deposits was further accompanied by a parallel movement in the composition of credits. The credits came to shift from shorter to longer accounts. This parallelism was a remarkable phenomenon and appeared to reflect a change in the very status of commercial banks.²

This trend for current accounts to decline in importance relatively to time deposits was projected into the first years of the depression. In 1931 and 1932 there was a remarkable shift of deposits from current to time and savings accounts in many countries including the U. S. A., British Dominions, Switzerland and Sweden.

¹ S. K. Muranjan, *Economics of Post-War India* (Second Ed.) p. 123.

² *Memorandum on Commercial Banks* (1925-33) League of Nations 1934, p. 7. Also the writer's *Industrial Finance in India* Ch. IV.

As percentages of Total Deposits.¹

	1929	1931	1932	1933	1936
U. K.					
Current Accounts ..	54.0	50.6	50.7	53.0	56.0
Time Deposits ..	46.0	49.4	49.3	47.0	44.0
(London Clearing Banks)					
U. S. A.					
Current Accounts ..	55.2	53.2	53.3	57.9	65.9
Time Deposits ..	44.8	46.8	46.7	42.1	34.1
(All Banks)					
Canada					
Current Accounts ..	30.4	29.5	24.0	25.1	27.7
Time Deposits ..	69.6	70.5	76.0	74.9	72.3
Australia					
Current Accounts ..	33.3	31.1	32.1	33.8	35.0
Time Deposits ..	66.7	68.9	67.9	66.2	62.8 (1935)
Sweden					
Current Accounts ..	18.9	17.2	17.6	18.6	23.3
Time Deposits ..	81.1	82.8	82.4	81.4	76.7
Switzerland					
Current Accounts ..	27.5	15.5	17.2	17.4	13.8 (1935)
Time Deposits ..	72.5	84.5	82.8	82.6	86.2 (1935)

The decline in demand deposits came to be arrested in a number of countries when the central banks there began to make large advances to their Governments to help them to meet budgetary deficits and also to increase the cash basis of the commercial banks. Instances in point are furnished by Mexico, Colombia, Ecuador, Chile and Brazil. In the case of

¹*Money and Banking* 1936-37. Vol. I. (League of Nations) Table XI pp. 150-51.

India also demand deposits appear to have recovered in 1932 as will be evident from the figures given below:—

As Percentages of Total Deposits.

	1929	1932
India (Six Banks) Current Accounts ..	32.0	42.0
Time Deposits ..	68.0	58.0

The remarkable shift noted above from time and savings accounts to demand deposits in the years of the War of 1939-45 was due to a variety of factors having different degrees of importance in different countries. As the *World Economic Survey* has pointed out, these factors were chiefly the overall preference for liquidity, low and declining interest paid on time deposits and a change in monetary turn-over. Conditions of uncertainty and emergency generated by the war tended to increase the liquidity preference of the people who showed a marked desire to hold their savings in the form of current accounts. War-time controls and rationing brought about a significant alteration in the monetary turn-over.¹ The volume of currency and deposits created by the banking system and spent by the Government increased, on the one hand, but physical controls, on the other hand, restricted the quantity of goods available for private consumption. In the circumstances idle funds tended inevitably to accumulate in the hands of the consumers and business men. In other words, the “velocity of circulation” declined. The spread of barter meant a further decline in the average velocity of circulation.

¹ *World Economic Survey* (1939-41) and (1941-42) League of Nations Geneva p. 99 and p. 131.

CHAPTER II.

CASH AND LIQUIDITY RATIOS.

On the assets as on the liabilities side, the distribution of banking assets underwent equally remarkable changes in war-time. Such changes, however, were not uniform in all banking systems and even showed marked divergences from one year to another in the same system. First, as regards the cash or primary ratio, the London clearing banks showed a practically unchanged cash ratio, not only during war-time when deposits sharply increased but also as compared with the normal pre-war period. The ratio has fluctuated between 10 and 11% as was usual in pre-war time.

TABLE¹

Cash Ratio (Cash Reserve as % of Deposits.)							
	1939	1941	1942	1943	1944		
					Mar.	Sept.	Dec.
London Clearing Banks	11	11	11	10	11	10	11

As the *Economist* has pointed out, such steady cash ratios over the war period indicate that the authorities took good care to create as much bank cash as would underpin the structure of credit on which the banks' participation in deficit financing depended. But apart from cash, there has been a revolutionary change in the composition of the quick assets, which make up the total used for calculating the liquidity ratio of the banks; and this liquidity ratio has steadily mounted

¹ *Fourteenth Annual Report of the B. I. S.*, p. 186.

to a height unknown and unattained in the pre-war days. In the pre-war period a liquidity ratio of 30% was considered to be quite a desirable mean. At the beginning of the war the ratio stood at 28.5%. Over the next four years it rose to a peak of 47.9% in September 1943. Although the cash ratio remained practically unchanged since 1939, the percentage of short loans to deposits fell from 6 to 7% in 1939 to nearly 4% in 1943 and that of bills discounted to deposits declined from a pre-war range of 12—16% to 6%. The make-up of the quick assets has been revolutionized by the emergence of a new item—the Treasury Deposit Receipts which came to represent 26% of deposits in September 1943 and closed the gap shown by the above figures.¹ Ever since their debut in July 1940, the centre of the stage of “quick assets” has been dominated by them. In 1944 the secondary reserve ratio (proportion of total liquid assets other than cash reserves to deposits) rose to 40%, two-thirds of which were made up by the T. D. Rs., and the total liquidity ratio (including cash) shot up to 50%, a degree of liquidity quite unprecedented in the banking history of England.² The percentage of T. D. Rs. to deposits rose still higher subsequently and in July 1945 stood at 41.4%.³

Now that the Treasury Deposit Receipts were tending in war-time to occupy the front rank in the structure of the liquid assets, it is worth while to examine their claim to be included as a component of true quick assets. They are non-negotiable and they can be encashed only under certain conditions, that is, they cannot be encashed to relieve a strained cash position. These two features qualify their character.

¹ *The Economist, Banking Supplement*, November 13, 1943 p. 1.

² *Fourteenth Annual Report of the B. I. S.* p. 187.

³ *The Economist*, August 31, 1946, p. 341.

They can no doubt be discounted with the Bank of England but this provision is not considered to be practical politics by the banks. Above all, the freedom of the banks to adjust their cash position by arranging their T. D. R. maturities is limited, for the initiative in determining the payments made week by week in new T. D. Rs. is beyond their power.

The peculiar feature of by far the most preponderant component of their liquid assets has obliged the banks to increase the liquid character of their other quick assets. They are increasingly growing concerned about the currency of the bills they will purchase and are as a rule inclined to take only bills of particularly short currency. In the pre-war days or even in the early war years bills having run a week or so at the discount houses could be resold to the clearing banks ; while in the present times bills must have run at least four or six weeks before they would be attractive to them. Bills would not be bought to-day if they had on the average to run more than six weeks, not to speak of the twelve weeks which was the practice until 1941. The new technique of open market operations which has cut at the very roots of the traditional relationship between the Bank of England and the clearing banks is a factor distinctly favouring the holding of short-dated papers by the banks. When the Bank of England to-day buys bills from the clearing banks in the course of its open market operations to ease the credit situation, it usually prefers very short-dated papers. By holding short-dated papers itself, the banking system fits well into the framework of the central bank's new technique of open market operations. Apart from the fact that the T. D. Rs. have grown to be the most important component of the bank's liquid assets, its existence furnishes a ready means for controlling the supply

of loanable funds and in the post-war years is likely to provide the authorities with a new instrument of monetary control.¹

In sharp contrast with the maintenance of steady cash ratios by the London clearing and Canadian banks,* commercial banks in a large number of countries have worked with mounting cash ratios in war-time. In Australia and New Zealand, cash ratios tended to increase during 1938-44.,

TABLE²

(Cash as % of Total Deposits)

	1938	1940	1941	1942	1943	1944
Australia						
(9 Banks)	11.0	11.9	12.5	25.1	33.7	41.1
New Zealand						
(Trading Banks)	15.4	23.1	21.7	23.2	23.1	31.1

The same trend of steadily increasing cash reserves is to be witnessed in the case of the Indian scheduled banks. Their total cash and balances with the Reserve Bank of India rose from Rs. 24,51 lakhs in 1939-40 to Rs. 116,56 lakhs in 1944-45. During the same period the proportion of this item to total deposits increased from 9.98% to 14.96% and the index of the percentage (with 1938-39=100) shot up from 105.1 to 157.5. The following table gives the details from year to year.

¹ *The Bankers' Magazine*, September 1945 p. 173.

	1939	1940	1941	1942	1943	1944
* Canada—	10.2	11.1	10.9	10.4	11.9	12.9

² *Money and Banking* 1942-44 (League of Nations) 1945 Table VI, p. 65.

TABLE¹
Scheduled Banks in India

Percentage of cash and balances with the Reserve Bank to total deposits.					
1939-40	1940-41	1941-42	1942-43	1943-44	1944-45
9.98	16.66	14.58	16.73	14.05	14.96
Index of the percentage of cash and balances with the Reserve Bank to total deposits (1938-39=100).					
105.1	175.4	153.5	176.1	147.9	157.5

Between cash and balances with the Reserve Bank, the latter have increased at a far quicker pace than the former which has been less erratic and more steady.

As regards the liquidity ratio of Indian banks, the composition of the quick assets which make up the total for calculating it is different from that in England. Such assets in England are made up of cash, short loans and bills discounted. In war-time, it may be recalled, to these has been added a new item, the T. D. Rs., which is occupying the front rank in the list of such assets. In the Continent law has given such assets a varied form and these include gold, government securities etc. In the absence of any law upto the present the practice of Indian bankers has been to regard "the total of cash, free investments and bills" as constituting the liquid assets.² From this point of view the liquidity ratio i.e., the ratio of cash plus investments to deposits in the case of the Indian scheduled banks was fairly high on the outbreak of the war and rose during the course of it. From 56% in 1939

¹ Statements XXV and XXVI. *Report on Currency and Finance*, Reserve Bank of India 1944-45.

² Statement of Mr. G. D. Birla, Chairman, United Commercial Bank Ltd., to the Share-holders Meeting, 28th March 1945.

it increased to 75.3% in 1943.¹ The ratio of liquid assets to deposits in the case of some individual scheduled banks stands to-day at the level of 66% and even 83%.*

The cash ratios in the U. S. A., however, rapidly declined and, as already indicated, gave rise to new problems.

TABLE²

	1939	1940	1941	1942	1943	1944
Member Banks—	31.6	33.2	26.9	21.3	17.4	15.7

The post-depression trends in commercial bank cash ratios may be contrasted in this connection with the war-time trends. While in England as a result of custom and tradition, cash ratios were maintained at a stable level, in other countries variations in the reserve ratios of commercial banks were fairly wide. As a result of gold influxes the commercial banks' cash ratio increased in the Netherlands from 7.2% in 1930 to 19.0% in 1932. In the United States also the same factor of a gold influx served to increase member banks' cash reserves in excess of the legal minima from \$866 million in January 1943 to \$3,084 million in January 1936. The cash ratio rose from 21.2% in 1926 to 23.3% in 1934, 27.2% in 1935 and 28.0% in 1936.³

The rules of the gold standard game required that changes in central banks' international assets were to be reinforced by concurrent changes in the domestic assets. As a matter of fact, however, in the inter-war period, it will be recalled, central banks' domestic and international assets frequently moved in the opposite rather than in the same direction. It is

¹ *Statistical Tables relating to Banks in India and Burma* 1942-43.

* Cf. The United Commercial Bank (85.2%) and the Bengal Central Bank Ltd.

² *Money and Banking* (League of Nations) 1942-44 Table VI, p. 67.

³ See *Money and Banking* 1938-39 Vol. I, (League of Nations) App. Table IX.

interesting to notice further that in many instances movements in central banks' international reserves were offset in the sphere of commercial rather than that of central banking, through the accumulation of idle cash reserves by commercial banks. If the central banks' domestic assets were very small at the beginning, automatic neutralization could not occur within the central bank but only outside it.¹ It is clear the central bank in such cases could offset an increase in its international reserve only upto the amount of the domestic assets held by it. Once these assets began to sink to or near zero, its power to neutralize disappeared. Such automatic offsetting in the sphere of commercial banking took place in the Netherlands, Switzerland and Sweden where the domestic assets of the central banks were small to start with. The cash reserves of the commercial banks were increased as a result of influxes of gold but no additional credit structure was built upon the increasing cash reserves and the gold inflows were practically offset.

¹ *International Currency Experience* (League of Nations) 1944 pp. 70-71, pp. 80-81.

CHAPTER III

ADVANCES AND BILLS DISCOUNTED.

In the war-time structure of assets, the reflex of the movements in cash and balances with the central bank was for a long time represented by advances and bills discounted. The latter in many countries exhibited, for a long time after the war, converse movements to those of the former. It is in respect of these that the most significant changes have taken place. As the *Eastern Economist* has observed, "It is difficult to disentangle the effects of seasonal changes, ups and downs of business, panicky war developments and recent control measures from the basic trend. Nevertheless the distinct trend of the declining importance of advances is discernible".¹ The advances of the London clearing banks dropped from £1,002 million in December 1939 to £754 million in December 1944. It will be found from the table given below that there has been a progressive decline in them.²

London Clearing Banks (In millions of £)					
1939	1940	1941	1942	1943	1944
1,002	906	807	773	743	754

Slight recoveries could be witnessed in some parts of the years (as in the first quarter of 1942) but they were really temporary deviations from an unmistakable downward trend since the outbreak of the war. This decline in advances affected all categories of loans and overdrafts.

In India the behaviour of "advances and discounts" in war-time has to be carefully examined. In line with Great

¹ *The Eastern Economist*, January 14, 1944 p. 43.

² *Fourteenth Annual Report of the B.I.S.* 1943-44 p. 186.

Britain these no doubt dropped but the fall was neither so great nor so continuous and persistent as there. A close examination of the behaviour of advances and discounts in the Indian bank portfolio will reveal that it was highly irregular, panicky war developments and seasonal factors influencing it to a considerable extent. Immediately after the outbreak of the war, trade and commodity prices experienced boom conditions and the volume of advances registered a sharp rise from Rs. 109·3 crores in August 1939 to Rs. 163·10 crores in March 1940. There was a persistent decline thereafter with the exception of the first three months of 1941. By September 1942 the downward trend of advances and discounts was over and the process of recovery definitely began thereafter. From the total of Rs. 80·12 crores in that month, the figure rose to Rs. 287·72 crores in March 1945, an increase of 259%. Their percentage to total deposits increased from 19·6 to 34·9%. The annual averages were, however, 23·8% in 1942-43, 27% in 1943-44 and 30·2% in 1944-45. Although the level of bank advances has remarkably shot up during 1942-45, it is not reflected in the rising percentage to deposits for the concurrent increase in the latter has been remarkably heavy. But it sharply contrasts with the pre-war (1938-39) percentage of 50·8%.¹

In seeking an explanation of the irregular, almost erratic, behaviour of this item in the balance-sheets of Indian banks, it should be remembered that the country's war-effort reached its peak from 1943 onwards. The inflationary marking up of commodity prices was no doubt an important factor but the principal factor making for the remarkable growth must have been the rising tempo of economic activity since 1943.² The

¹ *Report on Currency and Finance*, Reserve Bank of India, 1944-45, p. 77.

² *The Eastern Economist*, December 21, 1945 p. 909.

decline in imports, shrinkage in the free sector of international trade, progress payments made by the government to war contractors and the general liquidity of business were, as elsewhere, the factors which had tended to reduce the demand for banking accommodation and had brought about the fall in advances. As the influence of these factors waned and the pace of economic activity began to increase, advances inevitably rose¹. There were also other factors contributing to the rise. Speculative elements must have been responsible to some extent. Further, the compulsory deposits under the E. P. T. and the "pay as you earn" scheme of income tax may be presumed to have induced business concerns to seek accommodation from their banks which they would not otherwise have done.²

The figures for the scheduled banks' total amounts of advances and discounts and their percentages to total time and demand liabilities are given in the table below³ :—

	Total Advances and Discounts. [In Lakhs of Rs.]	Percentages to total liabilities.
1938-39	120,71	50·75
1939-40	131,14	53·38
1940-41	125,97	46·86
1941-42	125,13	39·23
1942-43	97,86	23·83
1943-44	161,73	26·98
1944-45	235,38	30·22

The declining trend of advances and discounts is also noticeable in Australia and Canada.

¹ *Report on Currency and Finance*, Reserve Bank of India 1945-46, p. 93.

² *Journal of the Indian Institute of Bankers*, January, 1945 p. 25.

³ *Report on Currency and Finance*, Reserve Bank of India 1944-45, Statement XXV p. 123.

Discounts and Advances as % of Liabilities.¹

	1936	1940	1941	1942	1943
Canadian Banks (11 Banks)	31·3	32·8	33·0	26·4	22·9
Australian Banks (5 Banks)	68·1	63·2	59·8	51·0	42·5

Decline in Bank Commercial Financing :

The causes of this declining importance of advances and discounts are to be found in England as in India in the loss of overseas markets and war-time restrictions on exports and imports, the reduction in the stocks of many manufactured and semi-manufactured commodities, the growth of liquid assets in the hands of individuals and business firms which have led to repayments of bank loans and on the industries' part to self-financing, elimination of middlemen, the concentration of trade and industry and the direct financing of war industries by the governments themselves.² In India, however, nowhere did we witness the same concentration of industries, limitation of civilian trade and the elimination of private finance from all Government controlled internal and external markets as was familiar in England. The system of "progress payments" under which war industries were financially assisted by the state was not developed to the same extent in this country as in England. In such circumstances the fall in advances was not so steep here as in England. Not only was the drop much less severe but the declining trend, as it has already been noted, was reversed from 1942. It must also be pointed out that though their percentage to deposits registered a marked decline, their absolute volume did not, only with the important exception of

¹ *The Economist, Banking Supplement*, October 28, 1944 p. 9.

² *The Statist, Banking and Commercial Review* (Half-yearly) August 29, 1942 pp. 1-3.

a period of 10 months from April 1942 to February 1943, fall below the pre-war level of Rs. 120 crores in 1938-1939. For the greater part of the period it was above this level and towards the close of the war it was distinctly upward.¹ Any way, the position of advances in the balance-sheets of the banks has definitely shifted and this is highly significant.

The altered position of "advances" in the bank balance-sheets had the immediate effect of producing a loss of revenue in the shape of interest and commission which the banks had to face at the time of an enormous rise in general expenses. But this decline in revenue was more than compensated for by additional income from the holdings of Government securities. In fact, as we shall presently see, there has been a remarkable switch-over from advances to Government securities in the structure of banking assets. This replacement of advances by securities reflects a fundamental change in the traditional function of commercial banks. Their business appears to be no longer the financing of trade and industry but the running of a specialised investment trust in all manner of Government securities.² They have been transformed from providers of short-time capital to industry to providers of long-term funds for Government.

The decline in the private sectors of business activity and the increasing intrusion of the state into the field of trade and industry in war-time strikingly illustrate the reduced importance of commercial-banking in Germany. In 1942 commercial bills and loans represented one-third of their assets as against 60 to 70% before the war. Advances on goods which accounted for 1/5 of the assets in 1929 practically sank to nil. Self-financ-

¹ *The Eastern Economist* January 14, 1945 p. 44.

² *The Statist, Banking and Commercial Review* (Half-yearly) August 29, 1943 ("Bank Advances and Industry"), p. 1.

ing and the provision of credits by various Government departments to the war industries rendered them independent of bank assistance and the importance of commercial banks as a traditional source of industrial credit greatly declined. The field of activity remaining open to the banks came to be increasingly narrowed and the banks were compelled to initiate a "concentration" movement and explore other convenient and profitable avenues of activity.¹ The closing down of 2600 branches in 1943 as part of the drive for rationalisation and the programme of geographical expansion aiming at "Germanisation" of business firms in occupied and annexed territories were some of the notable steps taken in self-defence. Dr. Funk, announcing certain changes in the method of financing armament orders in a speech in 1942, had raised hopes in the minds of German bankers that they would be able to resume their business of industrial credits on a normal scale.² But these hopes remained unfulfilled still in 1943 although the practice of advance payments on munitions contracts had been suspended a year earlier.³

This downward movement in advances has been a feature which has been viewed with profound disquiet, if not alarm, by bankers every where—in England, Germany, the U. S. A. and India. It has, as the *Economist* has remarked, cut at the very root of a type of asset which is at once most remunerative and most representative of genuine commercial banking tradition.⁴ Bankers are looking forward to the day when they will be able to hold more of these assets.

¹ *The Statist*, July 4, 1942 pp. 492—493 ("War-time Banking in Germany").

² *The Statist, International Banking Section*, November 28, 1942 ("Banking in Germany") p. 8.

³ *The Statist, International Banking Section*, November 27, 1943, p. 14 ("German Banks in Total War").

⁴ *The Economist, Banking Supplement*, September 20, 1941.

CHAPTER IV

BANKS AND WAR FINANCING

The part played by the commercial and central banks in war financing depends on the extent of the preference of the public to hold bank deposits or bank notes. In countries like England, the U. S. A. and the British Dominions, where the public holds a large amount of its money in the shape of bank deposits, the commercial banks have furnished a greater proportion of the loans and the direct share of the central banks in war financing has been relatively small. In the highly developed banking systems of England and the U. S. A., the increase in the central banks' holding of Government securities, while meeting the demands for currency in circulation, was mainly designed to furnish an adequate cash basis to the commercial banks so that they might themselves take up the Government loans. Open market operations and reduction of reserve requirements were the devices adopted to provide the increased reserves to the commercial banks. In countries where the public is accustomed to hold large sums of money in the form of cash rather than of bank deposits, the central banks have taken up a greater proportion of the Government debt than the commercial banks. Bulgaria and Finland are cases in point, where the relatively larger participation of central banks in the financing of Government loans was reflected in the increase in note issues as compared to bank deposits.¹

Generally speaking, the commercial banks in most of the belligerent countries were called upon to take up not only that

¹ *World Economic Survey 1941-42* (League of Nations) pp. 120-121.

portion of the short-dated Government securities which the central banks had not taken up but also to purchase large blocks of long-dated securities issued by the Governments. As the central banks were exempted in many instances from the existing legal limits on the amount of their direct loans to Governments, the commercial banks in their turn in some countries came to be statutorily obliged to maintain a portion of their assets in Government securities.

Detailed figures for the distribution of the ownership of government debt are not available for all countries. But for a number of countries it is possible to estimate approximately the proportion of the Government debt absorbed by the banking system and even its distribution between the central and commercial banks. In the case of almost all countries involved in the war the percentage of Government debt absorbed by the banking system has been fairly large. But this percentage has differed from country to country, being the largest in Japan and being larger in the case of the U.S.A. than in that of the U.K. Within the banking system itself again, the percentage of absorption by central banks has been greater in some countries than in others.

The war-time balance-sheets of commercial banks almost universally reveal the domination of the gilt-edged security in the composition of their assets. Ever since the outbreak of the war there has been a progressive increase in their "investments" of which the bulk has consisted of treasury bills and Government securities. By 1941 British banking had passed a significant milestone in that the combined total of "loans and advances" came to be exceeded¹ by "investments" for the first time in that year.¹ By the end of 1944 the London clearing banks' hold-

¹ *The Economist, Banking Supplement*, September 20, 1941.

ings of Government securities (Treasury Bills, Treasury Deposit Receipts and Government long-term securities) totalled £2979 million and in the course of 1945 they passed the £3000 million limit, constituting more than 66% of the balance-sheet totals of the banks. More than two thirds of the banks' deposits thus came to be covered by Government securities and the banks may be said to have partaken of the character of investment institutions in some respects.¹ In 1941 the trading banks of New Zealand increased their holdings of Government securities by 31%, the commercial banks of South Africa by 36% and those of the Argentine and Sweden by 100%. In the same year in Germany the holdings of treasury bonds and Reich loans constituted 56% of the total assets of the five leading commercial banks as against 28% in 1939.²

In the following table will be found the progressive rise in the holdings of Government securities among the "Investments" of commercial banks of a number of countries.

TABLE³

Commercial Banks' Investments.

(In 000,000's of National Currency.)

	United Kingdom (Joint Stock Banks in England and Wales.)	Canada.	New Zea- land.	South Africa
1939 Govt. Securities	548	1524	15.2	52.1
Other „	85	122	0.3	4.2
1940 Govt. Securities	712	1432	17.5	73.5
Other „	82	99	0.5	3.7

¹ *Fourteenth Annual Report of the B.I.S.* (1943-44) p. 187. Also *Fifteenth Report* p. 69.

² *World Economic Survey*, 1941-42 p. 124.

³ *Money and Banking*, (League of Nations) 1942-44 Table V.

	United Kingdom (Joint Stock Banks in England and Wales.)	Canada	New Zea- land.	South Africa
1941 Govt. Securities	949	1670	23'0	100'5
Other „	949	87	0'8	3'7
1942 Govt. Securities	1072	2210	34'3	124'8
Other „	69	83	1'0	4'1
1943 Govt. Securities	1102	2867	36'1	186'4
Other „	72	72	1'9	4'7
1944 Govt. Securities	—	3372	36'1	194'0
Other „	—	2'5	78	4'1

The case of the American banks' participation in war finance calls for a somewhat detailed investigation. There has been an undercurrent of feeling that the Treasury was highly successful in its war loan drives and had to depend relatively little on the commercial banks. The banks' participation in war finance appears to be small and the Treasury's policy, it has been urged, has been remarkably non-inflationary. But a careful examination of the position will at once reveal the large extent of deficit financing undertaken by the banks in the country. Between October 1942 and December 1943 the holdings of U. S. Government securities on the part of commercial banks increased by \$25,000 million ; and those of the weekly Reporting Member Banks increased another \$2,646 million by February 1944. Besides, large loans were granted for purchasing and carrying securities, mostly issues of the Federal Government. During October 1942 and February 1944 such loans granted by the Reporting Member Banks increased by nearly \$2,000 million. During these sixteen months the commercial banks' financing of the Federal deficit

amounted to more than \$30 billion which exceeded 33% of the increase in debt. The banks, though appearing to have participated only to a small extent, actually participated very largely. The explanation is to be found in the fact that although the greater part of the debt was primarily distributed to non-bank buyers, there took place a "leakage" or secondary distribution of the larger proportion of it to the banks themselves.¹ In the process of acquiring such a large part of Government debt, the commercial banks involved themselves in providing the general public with large amounts of cash. As a consequence, the reserve position of the commercial banks became considerably strained and the excess reserve declined sharply. The table given below shows the American member banks' holdings of Government securities.

TABLE²

Member Banks' Investments. \$ (000,000's)		
1939	Government	. . 17,020
	Other	. . 2,950
1940	Government	. . 18,836
	Other	. . 2,970
1941	Government	. . 22,629
	Other	. . 2,871
1942	Government	. . 40,511
	Other	. . 2,654
1943	Government	. . 55,677
	Other	. . 2,294

¹ *The Economist*, April 22, 1944 ("American Banks and War-Financing") p. 539.

² *Money and Banking* (League of Nations) 1942-44 p. 205.

More than 70% of the total earning assets of the commercial banks in the U. S. A. came to be made up of Government securities in 1944. About the same percentage of the earning assets was composed of such securities in Germany, France and Belgium. In Canada it was 50%¹ As regards the percentage of Government debt absorbed between the central and commercial banks, the Japanese commercial banks easily top the list with an absorption of 82.2%. Next come the commercial banks in the U. S. A., Canada and the United Kingdom with 33.9%, 16.9% and 16.2% respectively. The central banks in all these countries took up a far smaller proportion of the Government debt as will be evident from the following figures.²

	Percentage of Govt. debt absorbed by the Banking System.	Percentage of debt absorbed by Central Banks.	Percentage of debt absorbed by Commercial Banks.
U. K. (1939-44)	24.7	8.5	16.2
U. S. A. (1939-44)	41.8	7.9	33.9
Canada (1939-44)	31.2	14.3	16.9
Japan (1939-43)	97.6	15.4	82.2
Finland (1939-43)	59.2	38.6	20.6

It will be seen that the participation of the British banking system in the absorption of Government debt was smaller than that of the American. It implies that large amounts of Government loans must have been taken up by non-bank investors. As a result of the liquidation of foreign assets, private investors in Great Britain re-invested the proceeds of the sale of the foreign securities in domestic government securities. Moreover, the central banks in sterling area

¹ *World Economic Survey* 1942-44 p. 186.

² *Ibid.*, p. 179.

CHAPTER V

RATIO OF CAPITAL AND RESERVES TO LIABILITIES

With the continued expansion of deposits in war-time as a result of increasing Government expenditure and deficit financing from the banking system, the proportion of capital and reserves to total liabilities came to be considerably depressed. Indeed the proportion had been falling for a long time and the war merely accentuated the decline. Between the War of 1914-18 and the onset of the depression the movements of this proportion bear a striking resemblance to those in war-time and show an almost universal trend towards reduction. In the United Kingdom the ratio had been shrinking even before the first World War. The principal causes of the falling ratio during the period 1900-1914 were, first, the banking amalgamations, tending to reduce paid-up capital and secondly, the steady decline in the price of Government securities, necessitating the utilisation of surplus profits in writing down investment holdings.¹ The period between the outbreak of the War in 1914 and the depression is a record of the efforts of the British banks to improve the ratio by increasing their capital resources being frustrated by the ever-growing liabilities. The ratio which had stood at 9·9% in 1914 dropped to 6% in 1919. The banks made determined efforts to increase their capital and reserves and in the post-war slump there was also a moderate contraction of deposits. But in 1925-26 the ratio was only 8% against 9·9% of 1914, although

. ¹ *The Bankers' Magazine*, October 1945, pp. 242?243.

capital and reserves totalled 60% above the 1914 figures. The banks continued their efforts and by 1930 their capital and reserves became twice as much as the total in 1914. But still the ratio was only 8·4% for the liabilities had been more than doubled in the meantime. There was a temporary recovery to 8·6% inspite of a reduction of capital and reserves, when during the liquidity crisis of 1931, foreign deposits were withdrawn. Thereafter with the return of foreign deposits and expansion stimulated by cheap money policy since 1932, the ratio steadily fell to 7·1% in 1939.* It has been further reduced as a result of the expansion inextricably bound up with war financing, as will be evident from the figures given below.

Excluding the Bank of England.¹

	1939	1940	1941	1942	1943	1944
Proportion of Capital and Reserve to liabilities.	7·1	6·3	5·4	4·9	4·5	4·0

As in England, so also elsewhere, during 1914-1929 there was a reduction of the ratio of the banks' own resources to their public liabilities. In the U. S. A. it dropped from 19·8% to 15·6%, in Canada from 17·5% to 9·8%, in South Africa from 16·2% to 12·2% and in Australia from 22·2% to 20·0%. Perhaps the most striking reduction took place in Germany where it dropped from 30·3% in 1913 to 7·5% in 1929.²

* A slight reversal of the trend towards a lowering of the ratio has been brought about by amalgamations in recent times, where these have been carried through by acquisition of the capital of the purchased bank without loss of its identity.

¹ *The Bankers' Magazine*, October 1945, p. 244.

² *Memorandum on Commercial Banks* (League of Nations) 1913-29 Table IV p. 26.

This decline in Germany was highly significant. The banks there were wedded to the practice of maintaining very high ratios of capital and reserves to deposits and as such constituted "Industrial Banks" in a sense unknown in England. This sharp fall in the ratio must reflect a change in their status. They were shedding their pre-war character of investment banks and growing akin to English deposit banks. In the post-depression years banking legislation, aiming among other things at the maintenance of minimum capital requirements, must have been responsible for arresting this downward trend. During 1929-34 the trend was reversed in a number of countries. Indeed in many cases, there was a progressive rise, as in Germany, France, Belgium, Denmark, etc. The rise can not, of course, be attributed in all cases to banking legislation; to a considerable extent, it was due to deposit contraction in the depression period, as the fall in the ratio in the previous period was the result of deposit expansion.

TABLE¹

Percentage Ratio of Banks' own Resources to Liabilities.

	1929	1932	1933	1934
Denmark	17.5	19.1	19.0	19.2
Germany	10.9	15.8	17.5	18.2
(all comm. banks)				
France (deposit banks)	19.2	28.5	28.5	30.9
U. S. A. (all banks)	15.4	18.8	17.2	16.1
Canada	9.8	12.3	11.2	10.8
Belgium	25.6	28.6	29.5	...

¹ *Money and Banking*, (League of Nations) 1937-38, Table XVI p. 162.

But increased ratios remained below the 1913 level. The movements, again, were not uniform and were downwards in many countries, notably in England where the ratio dropped from 7·4 in 1929 to 6·7 in 1934. In 1936 the ratio, once again, began to fall as in the pre-1929 days. During the War of 1939 this fall was sharply accentuated owing, as already noted, to the tremendous growth of deposits, the “counterpart of monetary inflation.” The tempo of decrease was much faster during 1939-43 as compared with 1920-29.¹

Capital and Reserves as % of Liabilities²

	1939	1940	1941	1942	1943
England and Wales. . .	5·2	4·6	4·0	3·7	3·4•
Canada . . .	7·4	7·6	6·9	6·7	5·1
France . . .	6·4	4·4	3·9	3·9	3·8

*As regards the ratio of capital and reserves to deposits in the case of the Indian banks, their experience is in common with banks in other countries owing to the same cause, *viz.*, the enormous increase in deposits as a result of Government expenditure. The conventional ratio is between 10 and 12 but there has been a marked decline in the ratio, specially since the phenomenal expansion of deposits in 1942 and 1943.³ The Imperial Bank's ratio dropped from 12·7 in 1939 to 5·3 in 1943 while that of the scheduled banks fell from 12·7 to 7·4. The table given below strikingly illustrates the declining trends.

¹ *The Eastern Economist*, September 28, 1945.

² *The Economist*, October 28, 1944, p. 8.

³ Sir C. D. Deshmukh's Presidential Speech at the Sydenham College of Commerce and Economics, Banking Association, 21st January 1944, *Journal of the Indian Institute of Bankers*, April 1944, p. 21.

TABLE⁴

(Ratio of Capital and Reserves to Deposits).

	1939	1940	1942	1942	1943
Imperial Bank	12·7	11·9	10·3	6·9	5·3
Other Scheduled Banks	12·7	11·9	10·4	8·5	7·4

A peculiar feature is to be found in a move among many banks to increase their own resources by new issues of shares with a view to maintain a proper ratio between them and deposits. The Government of India have accorded sanction to such increases of capital wherever justified. The old established banks like the Central Bank of India, the Bank of India etc. taking advantage of market conditions issued their shares at a premium and thereby augmented their reserves considerably.¹ The smaller banks, with a view to attain the status of scheduled banks, also made fresh issues of capital.

In many quarters, however, this tendency on the part of banks to increase capital has found no support. It has been argued that banking rests on the confidence of the people and an adequate amount of sound assets, carefully distributed, rather than on large capital. An inflated capital structure would induce risky investments and prove a dead weight on earnings. This view appears to be held by many Bank Chairmen in India and banks, in several cases, having deposits amounting to 16-20 times their paid-up capital, have been reluctant to improve their capital deposits ratio.² The question of the desirability of a high capital-deposits ratio

⁴ Calculated from data given in *Statistical Tables Relating to Banks in India*, 1939-43.

¹ Cp. Speech of Sir Homi Mody, Chairman, Central Bank of India, 27th March, 1946.

² *Journal of the Indian Institute of Bankers*, January 1945, p. 26.

will be discussed later on in the context of banking legislation. At the present moment, it may be simply observed that the proportion of capital to liabilities is of no mean significance for two principal reasons. In the first place, it serves to inspire confidence among its customers ; and in the second place, it furnishes a guarantee that the obligations undertaken by the bank, as a trading business, will be met. When a bank incurs losses, these are borne exclusively by the proprietors and have to be made good out of current or past profits accumulated for the purpose and therefore, constituting a portion of the capital employed in the business.¹

¹ *The Bankers' Magazine*, October 1945, p. 241.

CHAPTER VI

BANKING EXPANSION IN INDIA AND ABROAD

The expansion in Indian banking presents a sharp contrast to war-time trends elsewhere. Banks in other belligerent countries, particularly in England and Germany, were confronted with a formidable array of problems which were spared to their more fortunate confreres in India. Evacuation, decentralisation, departure of the clearing from the metropolis and frequent bombing raids leading often to destruction were factors which did not very much affect Indian banking. There was further the question of manpower shortage with which banks elsewhere had to contend. All these phenomena were to be observed in Germany on a large scale and they restricted the growth and activities of German banking to a considerable extent. Air bombardments damaged most of the Berlin banks in 1943-44 and in many cases their head offices were destroyed. Their underground treasuries, however, generally escaped destruction and the payment mechanism could be got into working order almost immediately. As a result of evacuations, deposits tended to shift from one part of the country to another. At the same time there was a movement towards decentralisation, higher officials being brought to the main branches in the provinces which settled their accounts directly among themselves and with the local branches of the Reichsbank.¹ German banking was affected not only by the air bombardments but also by the

. ¹ *Fourteenth Annual Report of the B.I.S.*, p. 207.

closure of branches. This closing down of branches began as a voluntary measure in 1942 and was completed in 1943.

The banking system of India not only withstood the strain of the war and showed "remarkable resiliency" but also in sharp contrast to the position in England, Australia and Germany gave evidence of a vigorous growth. One of the most outstanding features of war-time banking in India has been the large number of new flotations and the opening of new branches by old banks. Indian banks, particularly some of the South Indian banks, were no doubt affected by the fall of Malaya and Singapore to Japan but this was only a passing phase. The total number of offices of scheduled banks including head offices, branches, pay offices, etc., which stood at 1,252 in September 1939 rose to 1,454 at the end of December 1941. This number declined to 1,405 on the 30th June 1942 but recovered to 1,600 on the 30th June 1943, 2,141 on 30th June 1944 and 2,715 on the 30th June 1945.¹

Although this picture of banking expansion is generally healthy and encouraging, yet it discloses certain undesirable trends. Some of these trends were discernible indeed even before the war but, thanks to the plethoric monetary conditions in war-time, they have been aggravated in recent years. According to the Governor of the Reserve Bank of India, they are sufficiently widespread to-day to call for caution. If unchecked, they are likely to produce undesirable repercussions on the post-war structure of Indian banking. Sir C. D. Deshmukh has summarised these tendencies under three broad heads. In the first place, some banks are inclined to acquire

¹ *Reports of the Ninth and Eleventh Annual General Meetings of Shareholders*, Reserve Bank of India, August 1943 and 1945, p. 24 and p. 20.

control of non-banking companies by purchasing their shares, without any regard to the price and yield and the effects of the transaction on their own financial position. Closely connected to this practice is that of interlocking of interests between banks and business concerns and the holding of large parcels of shares of companies in which the directors or the management are interested and even the flotation of investment trusts for such purposes. All this clearly amounts to the utilisation of the depositors' money for the benefit of the management against the traditional canons of safety, yield and liquidity. In the second place, some banks are resorting to indiscriminate branch banking in places, which are already well banked, with a view to attract deposits at high rates of interest. The practice will inevitably lead the banks to assume undue risks so that they may be able to make larger profits. In several cases the expense incurred on running branches is out of all proportion to the resources of the institution or the capacity of the head office or the availability of the requisite technical personnel. In the third place, the excessive "window dressing" at the time of balance-sheet publications practised by a few banks gives an altogether erroneous picture of their financial position. It should also be pointed out in this connection that several banks have frittered away their "windfall profits" in making large dividend payments instead of utilising them in building up their reserve position.¹ If the banks abandon these practices and confining themselves to the pursuit of sound policies are not impatient to show spectacular profits for every branch, they can well stand the strain of the post-war period. The Governor has given his assurance

¹ Address of the Chairman, Reserve Bank of India, at the *Eleventh Annual General Meeting of Shareholders*, 6th August 1945.

that the Reserve Bank will always be ready to extend its assistance to them in the post-war period whenever they will be involved in difficulties not of their own making.¹

¹ Speech of Sir C. D. Deshmukh (*Sydenham College of Commerce*, 31st January 1944).

CHAPTER VII

BANK EARNINGS

In ordinary times banking profits are chiefly derived from commercial loans and overdrafts and investments in Government securities. In war-time the principal factors that affected the gross profits of banks were the enlargement of banking resources and the reduction of business loans and advances. If the banking resources had not been swollen as a result of deficit financing, profits would have touched a critically low point in the war period. The increases in income-tax have, however, lowered the published profits to some extent.

But the stated profits are scarcely a suitable guide to profitability in any one year. Because of the high rates of income-tax, an accounting factor has to be taken into consideration. Banks might have adopted either of the two following methods. They might have appropriated the gross amount of dividend plus tax on it. Or they might have charged their profits with all the tax due and appropriated from them the net sum required to pay dividends. The latter method would show smaller profits and lower dividend payments than the former.¹ Again percentage changes of profits in the case of individual banks from one year to another would not, under the present conditions, reflect relative profitability but would merely indicate the general attitude of the Directorate and their inner reserve policy.²

The banking extension in India reviewed above must dismiss the idea of a general decline in bank earnings at least for our country. At the bottom of this extension there must

¹ *The Bankers' Magazine*, August, 1945, pp. 83-84.

² *The Economist*, January 12, 1946, p. 70.

have been the prospect of remunerativeness. In spite of the various war-time restrictions on their activities the banking system has made high earnings not only in our country but also elsewhere. There is one remarkable point of contrast between the Indian and British banking systems in this respect. British banks have made large profits* but they have not been liable to the E.P.T., although their earnings must have touched the border line.¹ Unlike British banks, however, some of the Indian banks have fallen under the E.P.T. axe.

The tendency of British banking profits to approach the critical level and just avoid liability to the E. P. T. raises an interesting question. To what extent does the E. P. T. affect banking policy relating to the choice between liquidity and profits? In normal pre-war times the point of equilibrium between the need for safety and the desire for extra profit was settled merely by a set of established conventions. In the circumstances banking policy was hardly influenced by changes in opportunities of profit. After the outbreak of the war and the imposition of the E. P. T., the situation was completely altered. When established rules were no longer in operation, there might be a tendency for banks, as soon as the E. P. T. line was touched, to place considerations of liquidity far above those of extra profit.² As a recent Report of the B. I. S. has observed, "the choice between liquidity and yield would seem to be pushed to the point where the former has been preferred at some sacrifice of the latter."³

* British Bank Profits. (£000's)					
	1943	1944	%Increase	1945	%Increase
Seven Banks . .	8,729	9,095	4.2	9,285	2.1

¹ *Fourteenth Annual Report of the B.I.S.*, p. 245.

² *The Economist*, August 12, 1944, p. 225

³ *Fourteenth Annual Report of the B. I. S.*, 1944, p. 248.

The progressive decline in new investments of British banks during 1941-44 has already been noticed. That decline was no mere accident but highly significant. It is also interesting to notice in this connection that long-term Reich securities were purchased by the Big Berlin Banks upto 1941 but were sold on balance in 1942 and 1943. Moreover, the aggregate taxes paid by them (which afford a good measure of bank profits) did no longer rise but significantly fell for the first time in several years.¹

(In millions of RM)

	1939	1940	1941	1942	1943
Taxation paid by five Big Banks of Berlin.	78	109	127	161	156

In the U. S. A., however, there was a continuous and persistent tendency for bank earnings to expand as is reflected in the figures of net profits of member banks during the period 1942-1944. The net profits increased from \$383 million to \$649 million. In the earlier stages of the war, profits were moderate and stood at \$347 million in 1939 and \$349 million in 1940. In the early thirties, as a result of the decline in earning assets and in interest rates, the profits had been sharply reduced and the year 1932 had even showed a negative profit or loss of \$255 million. Steps had indeed to be taken during this period to reduce expenses and increase earnings. Banks ceased to pay interest on demand deposits and introduced and increased service charges. The large increase in war-time earnings of American banks, as elsewhere, is principally due to the enormous holdings of Government securities on the part of the banks. Member Banks' holdings of Government securities amounted in 1944 to about 70

¹ *Fourteenth Annual Report of the B.I.S., 1944.*

billion dollars which was nearly four times the 1941 average level of \$18 billion. In 1941 such securities constituted half of the earning assets, in 1944 they constituted three-fourths. In the earlier stages of war financing banks were inclined to hold low rate short-term securities, but in the later stages there was a tendency on their part to switch over to the highest coupon securities that might be available, particularly the 2% bonds outstanding. An analysis of holdings of Government securities of member banks reveals that Government securities maturing within five years comprised 40% during 1940 and 1941 of the total of holdings, but 56% at the end of 1944. As bank earnings have been increasing much faster than expenses, the reduction of maximum coupon rate of interest on new issues in the Seventh War Loan drive will not burden the banks unduly. A large proportion of the banks' increased earnings has been added to capital accounts in recent years. But the ratio of net profits increased from 6·7% in 1941 to only 9·7% in 1944.¹

As regards the earnings of Indian banks in war-time, relevant statistics are not available. The *Eastern Economist* has recently estimated that the total earnings rose from Rs. 725 lakhs in 1938-39 to Rs. 16·6 crores in 1943-44. By deducting the interest allowed on deposits (at an average rate of 2% upto 1941-42, thereafter at a flat rate of 1½%) from gross earnings, gross profits have been estimated at Rs. 919 lakhs in 1943-44.² The net profits are, however, considerably less than this amount owing to the sharp rise of administrative expenses.

Figures relating to the net profits of Scheduled Banks are

¹ "Member Bank Earnings" Art. in the *Federal Reserve Bulletin*, May 1945, pp. 429-31.

² *The Eastern Economist*, November 10, 1944, p. 503.

given in the "Statistical Tables Relating to Banks in India" 1941-44 published by the Reserve Bank of India.¹ If the figures are totalled up, they will indicate the extent of net profits made by this class of banks. These figures, of course, are not comparable to the estimates of the *Eastern Economist* given above, for the exchange and non-scheduled banks are not included here. The profits of the banks in question rose from Rs. 206.1 lakhs in 1941 to Rs. 249.3 lakhs in 1942 and Rs. 393.8 lakhs in 1943, the figures for the deposits being Rs. 237.9 crores, Rs. 352.8 crores and Rs. 534.2 crores respectively. It is clear profits have not increased in the same proportion as deposits. The rate of return on paid-up capital works out to 15.4%, 14.8% and 18.4% in the three years. Taking the extent of monetary expansion into consideration, it does not appear that the banks have made much too excessive profits. Gross earnings of Rs. 16.6 crores on deposits of Rs. 600 crores and net profits of Rs. 393.8 lakhs on deposits of Rs. 534.2 crores are not unduly high. The expense ratio in India must have increased relatively to that in other countries. The cost of material in India has been much higher and the number of offices has considerably increased while branches have been closed elsewhere. The opportunities for profit making have also been severely curtailed. Restrictions on advances against commodities and bullion and on movement of goods, progress payments by the government, self-financing on the part of industry, reduction in rates earned have all stood in the way of excessive profit making. Nevertheless the banking system as a whole has made more, not less profits.

¹ See *Statistical Tables Relating to Banks in India* Table No. 10. (Liabilities and Assets of the Indian Joint Stock Banks as published in their balance-sheets).

CHAPTER VIII

POST-WAR PROSPECTS AND PROBLEMS

The analysis of the war-time pattern of bank balance-sheets as given above inevitably raises the question : the distortion may have been beyond recognition but do the war-time changes represent a permanent orientation of the structure of bank assets and liabilities ? Banking and financial circles, whether in England, India or the U. S. A., are at the moment deeply concerned about the nature of the problems the future holds for them. Among the multitude of questions that must be exercising their minds, the following easily stand foremost: In the first place, will the persistent expansion of bank deposits witnessed during the past six years continue or be stopped and even reversed ? In the second place, will the government securities continue to dominate the investment portfolios of commercial banks in the same manner as in war-time ? In the third place, are the banks likely to lose on their investments after the war ? And in the fourth place, will loans and advances of commercial banks be restored to their pre-war importance ?

Banking trends in the immediate post-war period will depend on a variety of factors. The state of economic activity and employment in the period of transition and the economic and monetary policies of the Government related to them will inevitably affect these trends. Whether public expenditure rather than private investment becomes the dominant feature of post-war economy, whether economic activity and employment are simultaneously increased and whether prices are deliberately forced down to an optimum level—all these factors will have an important bearing on immediate trends

in banking.¹ The post-war banking structure will also depend to a great extent upon whether the pace of reconversion will be quick or slow and whether the government will follow a cheaper or dearer money policy.

An important post-war banking problem in India as in the U. S. A. and elsewhere is the question of a re-adjustment to a lower level of deposits or depreciation of assets. As regards deposits, it is hardly likely that there will be a contraction of total deposits. In countries like the U. S. A., where the banking system is not modelled on multi-branch British lines, compulsory shifting and concentration of war industries may have produced an uneven regional growth of deposits which may be modified by a reconversion to peace-economy. But even there, as Mr. Goldenweiser has observed, there will be no total contraction of deposits, the loss in one area being compensated by a gain in another. Mr. Goldenweiser is convinced that deposits will stand at a high level for many years after the war.² The outlook for deposits does not appear to be uncertain and dark. Reconversion, rehabilitation, full employment and various other problems of peace economy indicate a government spending programme far ahead of tax revenue for many years to come. In the circumstances, deficit financing is sure to continue for the next few years. This is broadly true not only of the United Kingdom and the U. S. A. but also of India.

In war-time there was an enormous expansion of the resources of the banking system. The war-expanded resources—the total volume of bank credit—will not probably shrink very much from the peak reached in war-time. One lesson

¹ *The Eastern Economist*, December 21, 1945, p. 910.

² *Federal Reserve Bulletin*, September 1944, Art. by Mr. E. A. Goldenweiser entitled "Commercial Banking after the War."

learnt from the first Great War is that credit is seldom destroyed. In spite of deliberate deflation and a fifty per cent fall of prices from their post-war high point and a long period of industrial stagnation, there was a withdrawal of credit amounting only to $8\frac{1}{2}\%$ of what had existed at the peak.¹ In the present post-war period, Government must be making strenuous efforts to prevent deflation, maintain the maximum of employment and keep low rates of interest. In such circumstances post-war economy is likely to be re-oriented to a further creation of credit, rather than its destruction.

While all these factors are likely to maintain the level of deposits in India, as elsewhere, in the post-war period, there is one feature peculiar to the Indian situation which may bring about a shrinkage of bank deposits. The feature is to be found in the likelihood of a post-war adverse balance of payments on international account. Now that the war has ended, India will require vast quantities of capital goods for the development of industry and agriculture, for the re-equipment of her mills and factories, for her railways, hydro-electric and irrigation projects. The imports of these capital goods would tend to contract her external resources as well as her bank deposits. But these imports would lead to speedy and intensive industrialisation of the country and would in due course stimulate economic activity and employment. The increased demand for bank finance that would thereby be created would more than neutralise the effects of a declining trend in deposits. In a country like India, where, as Sir C. D. Deshmukh points out,² a large amount of industrial slack has to

¹ *The Economist*, February 14, 1942.

² Speech of Sir C. D. Deshmukh (Sydenham College of Commerce, Banking Association) *Journal of the Indian Institute of Bankers*, April 1944, p. 20.

be taken up, fears of a reduced level of bank deposits may be discounted with the development of the capital expenditure programme and the rising tempo of industrial progress. The prospects of a serious decline in the volume of bank deposits due to panicky withdrawals or monetary contraction are also largely illusory. Even though the war has stopped, bank deposits and note issues have been maintaining their upward trend, as will be evident from the figures given below¹ :—

(In lakhs of Rs.)			
	20th Nov. 1945	7th Dec. 1945	22nd Mar. 1946
Reserve Bank of India	11,88,54	12,00,54	12,38,29
Total Notes			
Scheduled Banks { Demand	673,74	688,03	700,99
Deposits { Time	273,15	275,00	296,44

As regards the composition of the bank deposits in India it will be recalled that there was in war-time a remarkable shift in favour of demand as against time deposits. During the six years of the war the former had increased by 412% while the latter rose by only 177%. The percentage of demand to total liabilities had increased from 57·0 to 71·7 while that of the time liabilities had fallen from 43·0 to 28·3. Recent trends, however, indicate that this wide disparity is being gradually reduced and the public's preference for liquidity is manifestly growing less. From the latter half of 1944 the tendency of the percentage of demand to total liabilities to increase appears to have been checked, if not reversed. It fell from 76·5 on 3rd September 1943 to 71·7 on 7th September 1945.²

¹ *Weekly Returns of the Reserve Bank of India.*

² *Report on Currency and Finance, 1945-6 Reserve Bank of India p. 93.*

It does not appear that the banks will be able to reduce their holdings of gilt-edged investments in the near future. Such reduction could have taken place to an appreciable extent only if the banks could sell them extensively to the public or if the public debt could be reduced. There is no prospect of large-scale sales of government securities to the public in the immediate post-war period. The public will then have many other uses of their cash rather than the purchase of government paper. The banks themselves might be disposed to keep them for they are their most stable non-cash asset. Government securities in the circumstances will continue to dominate the peace-time pattern of bank investments as they did during the war. This dominance of Government securities, as briefly noticed before, has far-reaching implications. Banking has been traditionally regarded as the "handmaiden" of industry and trade. But the "handmaiden", as the *Statist* has observed, to all intents and purposes left her traditional job and enlisted in state service for the duration of war.¹ It would have been well if it were only for the "duration". The immediate prospects are of her continuing to be "in commission" still. Banking will hardly be able to resume its normal function of financing productive effort of all kinds, until demobilisation has proceeded further and controls have been relaxed still more. In the strenuous economy of the war, the banks, as already noted, had become the complaisant, if not entirely willing, providers of state finance. In the peace economy of the future they will continue to run the same specialised investment trust department in government paper. There is hardly any likelihood

¹ *The Statist, British Banking Section*, June 1945 ("Banking in the Doldrums"), p. 6.

of a significant modification of their subordination to the dictates of Governments' financial policies.¹

A feature of banking common to many countries in war-time has been the very important place obtained by the investment portfolio as against "advances and loans". A crucial question is that of the restoration of the pre-war importance of the banks' "loans and advances". It is a question which is fraught with special significance for the banks not only because they constitute their most remunerative asset but also because they are used for providing working capital to industry which is of the essence of banking. On the one hand, war-time bank balance-sheets have assumed a semi-investment trust like character ; on the other hand, balance sheets of corporations have grown markedly liquid. A great deal of the enormous increase in total net deposits has accrued to industrial and business accounts. In the case of Great Britain the following figures relating to the London clearing banks disclose illuminating trends :—

London Clearing Banks.¹

(In millions of £)

	June 30, 1940	Dec. 31, 1941	Dec. 31, 1942	Dec. 31, 1943
Total Net Deposits	1507	2522	2856	3289
Personal Deposits (net)	617	692	820	972
Other Deposits (net)	890	1830	2036	2317

Figures for the liquid asset holdings of business and individuals are available for the U. S. A. In the five years from the end of 1939 to the end of 1944 the holdings of these

¹ *The Statist*, International Banking Section, November 25, 1944, p. 8.

² Source : "An Analysis of the sources of War Finance and Estimates of the *National Income and Expenditure*" (cmd. 6520).

liquid assets comprised of cash, deposits and Government securities increased from \$66 billion to \$194 billion. Businesses have added tremendously to their holdings of such liquid assets during 1939-44.

Liquid Asset Holdings ¹ (In billions of \$)						
	1939	1940	1941	1942	1943	1944
	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.
Total						
Business holdings	17.5	20.3	24.2	37.0	51.6	66.0
Total						
Personal holdings	48.4	51.3	57.9	75.7	101.4	127.6

The liquidity of industry is likely to be further enhanced by post-war refunds of E. P. T. and fortified by tax relief in the form of income tax concessions and reductions and abolition of the E. P. T. Moreover, there is every where a definite trend for industry to rely on self-financing. In such circumstances the rôle of the banks as suppliers of working capital to industry will grow less important and the outlook for loans and advances does not appear to be bright. Mr. Geoffrey Crowther holds the view that the "advances" of British banks may at least recover the level lost during the war but no more. Business concerns will be likely to dispose of a portion of their large holdings of Government paper in the event of their need of cash. Indeed they would be induced to sell their "gilt-edged" rather than borrow against it owing to a differential of a significant percentage between the yield on "gilt-edged" and bank interests. Although bankers might eagerly look forward to a resumption of their

¹ *Federal Reserve Bulletin*, June 1945, p. 533.

traditional business on a large-scale, their hopes are not likely to be fulfilled in the foreseeable future.

But although it may not be possible to paint a very rosy picture of "advances and loans", yet the future need not be so sombre and bleak. A note of quiet optimism rather than one of unbridled pessimism may, perhaps, be more appropriate in this respect. In an industrially progressive and dynamic society, there would be no lack of energetic producers and traders who would seek to expand their scale of operations with the help of extra temporary capital. The business unit is, no doubt, tending to grow in size and self-financing is becoming increasingly easy and has to be reckoned as an important factor in the trend of bank advances. Nevertheless, there still exists a considerable scope for banking assistance to business men of vision and directive abilities whose scale of enterprise exceeds their capital resources. To believe that the trend of bank advances will either be downward or static is to believe that all progress will be throttled and the entire economy will be stagnant. But the indications are that we are just on the threshold of an era of extraordinary national and world economic expansion.

It should also be remembered that stocks have heavily run down, obsolescence and depreciation of plant have seriously accumulated and vital replacements and repairs have been in arrears during the past six years. The problem has nowhere been more acute than in India. All these deficiencies must have to be made good at post-war prices. There is hardly any likelihood of prices coming down in the immediate future. Prices are believed to rise more. In the circumstances a deficiency rather than a redundancy of working capital is indicated. Here is plenty of scope for bank

advances and loans. As the *Statist* has observed, there is a likelihood of a fairly great demand for the service of the banks for assisting the economic life of the nation in peacetime. Capital might be redundant in some of the war industries but there will be an acute shortage of capital over a wide range of peacetime industries. In some instances reconversion may be fairly easy but "the potential economy of capital available in this way would be limited."¹ A good deal of bank financing of industry is of what has been called the "rescue" description, helping to carry stocks and tide over temporary difficulties.² Few business undertakings are able to escape such situations. In their hour of need, they will inevitably resort to the banking system.

There is one factor in favour of resumption of the business of loans and advances—the relaxation of war-time controls and restrictions. A considerable amount of pressure is likely to be exerted for the speedy unwinding of the war machine which has been built up by the past six years' effort. A great deal will no doubt depend upon the manner in which the controls are demobilised. The war-time restrictions imposed on bank advances, prohibiting banks from lending in particular directions or against particular types of security, are expected to be lifted. The normal channels of trade may gradually be re-opened and a revival of foreign trade may stimulate banking business.³ In India there are already in evidence signs of a gradual revival of this line of business. The volume of scheduled banks' advances and bills discounted registered an increase of Rs. 80 crores in December 1945 as compared with December 1944. The ratio, however, as

¹ *The Statist*, August 29, 1942, ("Bank Advances and Industry").

² *The Statist*, International Banking Section, June 9, 1945, p. 7.

³ *The Economist*, January 22, 1944.

noted before, is still substantially below the pre-1939 level. How quickly the pre-war level will be reached will depend upon the pace with which economic planning proceeds in the country. In the period lying immediately ahead of us, however, the demand for bank funds may not be very active because of the large liquid resources built up by trade and industry in war years.¹

If the forecast of the future of advances we have made is wrong and if the war-time decline continues well into the post-war years, the banks must be undergoing a permanent change of character, and not merely passing through a temporary phase of abnormality. Indeed in many countries, the declining trend in advances had been manifest even before the war and it was merely accentuated during it. In such countries, the change in character must have already set in long before the present times. The commercial bank has been traditionally conceived as a collector of savings of the public and a distributor of these to finance the working capital needs of trade and industry. That description of the commercial bank has long been partially misleading. In war-time it became almost wholly incorrect. Deposits in war-time came into existence as the result of conscious credit creation and as such can not be regarded as savings. On the liabilities side of their balance-sheets the banks, therefore, are not to-day so much collectors of the savings of the people as holders of their cash. On the assets side, again, they are providers of long-term finance to governments rather than of short-term capital to industry. As the *Economist* has pointed out, this remarkable change in their functions must have

¹ Speech of Sir Homi Mody, Chairman, at the *Annual General Meeting of Shareholders*, Central Bank of India, 27th March 1946. *The Capital*, April 4, 1946, p. 606.

far-reaching repercussions on their structure and operations. In the first place, banks will inevitably seek an alternative outlet for their resources in the long-term financing of industry. In the second place, the liabilities instead of the assets of the banks may, henceforth, have to carry the cost of business. With Government securities predominating on the assets side, the banks have been earning on the average around 2 to $2\frac{1}{2}\%$ in place of the former 5% when loans and advances were fairly large in amounts. The holder of a current account deposit in the circumstances is in effect accepting a service from the banks, rather than rendering them one and must be prepared to pay for it.¹

There is another important problem. The banks may very well desire to finance trade at 5% rather than hold the gilt-edged at $2\frac{1}{2}\%$ but will they be free to switch over from Government securities to advances without any risk of loss on their investments? A great deal will depend on the state of post-war trade and the kind of economic and monetary policy pursued by the governments. If the post-war economy is in the grip of a slump and prices topple down and trade declines, the demand for working capital may not exceed the war time "low". In such circumstances the banks will find it convenient to hold their government securities as the only suitable avenue for the employment of their funds. But if trade expands and there is a consequent increase of demand for working capital on a large scale, the problem of how to replace government securities by "advances" without loss should engage the serious attention of banks. Either the banks would have to part with their investments at a loss or their assistance to post-war trade will inevitably be restricted.

¹ *The Economist*, February 1, February 7 and February 14, 1942 ("The Banks in Transition.")

But the clash between the interests of trade and those of the banks may be averted if the Government follows an expansionist policy in the post-war years. The adoption by the Government of a compensatory public spending policy with a view to combat the post-war depression would enable the banks not only to retain their gilt-edged but also to meet the trade demand for working capital by means of increased deposits, then accruing to them. Further, as the *Eastern Economist* has observed, the government policy of funding their war-time debt must not be deflationary in effect. Within three or four years of the end of the war, the short loans that are likely to fall due for payment have been estimated to amount to a figure of Rs. 300 to Rs. 400 crores. The banks holding them might sell out or be repaid by the Government. But if the Government attempts to raise this huge amount by issuing further loans, there will be the inevitable conflict between the demand of the government and that of trade. Monetary stringency may develop as a result and interest rates may possibly rise. It would be desirable to avoid carefully such a deflationary policy. There should be no delay in funding. The funding should be immediate, before money has begun to grow scarce and outlets for new industrial investment have increased rapidly.¹ Even if a policy of currency contraction were followed, the banks will not necessarily be injured. In such an event the banks would be simply holding their government securities and meet the small demand for current trade finance ; for they would be able to satisfy the demand for deposit withdrawals out of their own liquid assets. But an expansionist policy is likely to benefit the banks and the community.

¹ *The Eastern Economist*, January 14, 1944, p. 45.

We are next brought to another subject which has been increasingly engaging the attention of economists and bankers, viz., the rôle which banks should play in the post-war financing of industries. The unprecedented war-time liquidity of the banks almost all over the world has raised the question whether they can depart from "orthodoxy" and develop, with profit and without risk, long-term lending policies to industry. We have discussed the question elsewhere at some length.¹ It will be sufficient to point out here that in the present circumstances of their war-expanded liquid resources and loss of their legitimate sources of income, they are being urged to explore new avenues for the employment of their funds by forging closer links with industry in the post-war period. The trend of opinion is remarkably similar in England and the U.S.A. in this respect. Lord Wardington in England and Mr. Goldenweiser in the U.S.A. believe that the banks would be justified in "widening their horizon" and breaking new ground so as to provide long-term and possibly permanent capital to industry. A number of Bank Chairmen in India also appear to hold the view that in the matter of finance for industries, the banks should adopt a more liberal policy.² Official pressure has already been brought to bear upon the British banks to undertake this function jointly with reference to medium and small industry. The London clearing and Scottish banks have subscribed to a portion of the capital of the British I.C.F.C. In India the inauguration

¹ See the writer's *Industrial Credit in War and Post-War Economy*, 1945.

² Cf. Sir Homi Modi (Chairman, Central Bank of India)—"It seems to me that the time has come for the traditional role of banking to be enlarged." Speech at the Annual General Meeting of Shareholders, 27 March 1946. Mr. Shanti Lal Mangal Das (Chairman, Exchange Bank of India and Africa). "The national interest calls for a broader conception of the place of banking in relation to industry than hitherto." *The Commerce* April 6, 1946, p. 598.

of an Industrial Investment Corporation has recently been announced by the Government. The proposed Corporation should be not merely a financing institution but also an agency for mobilizing the investible resources of the country and for guiding and controlling investment.¹ The Indian commercial banks, along with the Reserve Bank, should be financially interested in this Corporation and thus help in the important task of post-war industrial reconstruction in the country.* If the shares of the Corporation are treated on par with government loans for the purposes of Sec. 17 (4) of the Reserve Bank Act and carry a government guarantee of a minimum rate of interest, they will prove very attractive to the banks. In case of need the banks will then be able to borrow from the Reserve Bank against such shares.

In this connection the declining trend of the ratio of capital and reserve to bank deposits in war-time calls for comment. The war-time relationship between the two, if projected on to the post-war scene, as it appears to be, can not be viewed with equanimity. It may be contended that the question of capitalisation is only of academic interest for the governments are heavily indebted to the banks. But it must be remembered that the governments have not indemnified the banks against loss and there is hardly any likelihood of their ever doing so. Apart from the question whether an increase in the capital-deposit ratio will or will not reduce the

¹ See Art. by the writer entitled "*Post-War Industrial Finance*" in *The Nationalist*, Puja Special, 1945.

* Since the above was written, a bill to establish the Industrial Finance Corporation of India has been introduced into the Indian Legislature and provisions have been made for the Reserve Bank and the Scheduled Banks to participate in its share capital. Out of 2,000 shares of Rs. 25,000 each the Reserve Bank may subscribe for four hundred shares and the scheduled banks for eight hundred shares.

(A Bill No. 52 of 1946, *Gazette of India*, November 9, 1946, pp. 274-75.)

risks of the depositors, a policy of long-term financing of industries in the post-war period which appears to be attractive to a number of banks here and abroad requires that the banks should get themselves properly equipped for this task by raising the ratio. In many instances to-day the ratios are much too low to enable the banks to fulfil the new functions adequately and without risk.

In conclusion, it is hardly necessary to point out that the limitations of war-time forecasts of post-war banking trends must be frankly recognised. We have been much too accustomed to look at banking developments through the spectacles of the old orthodoxy. During the past fifteen or twenty years the deviation from the classical pattern has been progressing continuously. Recent years have witnessed not merely a distortion of the classical relationship but, in many respects, a complete reversal. The orthodox pattern is not the same reliable guide to future trends as it used to be in the past. In the circumstances a great deal of caution has to be exercised in making any forecast of immediate post-war tendencies. It must be frankly recognised that many of the prophecies may be utterly falsified. Remembering fully the limitations of our forecasts, let us carefully examine what changes have actually taken place in the British banking structure in the first post-war year ending in August 1946. It will be found that there has occurred a revolutionary change in the pattern of bank balance-sheets, indeed more revolutionary in some respects than in war-time.

British Banking in the First Post-War Year :

First, as regards "advances." On the one hand, the response of bank advances to the demands of industrial conversion has been quite sharp. Indeed the expansion in this item has

far outstripped the expectations of the most optimistic bankers. During the period August 1945—August 1946 advances of the London clearing banks increased from £756.3 million to £895.8 million.¹ This increase is to be regarded as a net increase. For there had been simultaneous repayments of advances by war-time borrowers on the cessation of war-time production and on the settlement of war-contracts. It would be dangerous, however, to draw any conclusion as to the future behaviour of “advances” from the experience of these twelve months. The course of advances in the future years will be determined principally by two factors, the rate of repayment of war-time debts and the tempo of reconversion, structural and otherwise. The former is likely to slow down and the latter to increase. There is another factor which has also to be reckoned with, namely, the extent to which the liquid resources figuring still to-day in the balance-sheets of many industrial companies will be adequate enough for the rebuilding of stocks and the full replacement of war-worn plant. The fundamental banking problem is still how to adjust the internal structure of the banks to a situation in which by far the greater proportion of their resources are lent to governments directly or indirectly. That problem does not appear to be solved by the prospects of “advances”. The performance of “advances” during the period under review was no doubt fairly satisfactory under the circumstances. But the function of direct lending to industry can hardly be expected to assume the same relative importance as in the days before the inauguration of the present cheap money policy. The ratio of “advances” to “deposits” stood at its lowest point in August 1945—15.5%. It is significant that the ratio has not

¹ *The Economist*, Banking Supplement November 16, 1946 p. 1.

appreciably increased in spite of the expansion of business during the next twelve months. It moved up to 17.2% only in August 1946. But it sharply contrasts with the 43.8% touched in August 1939 and a peak of 58% reached a decade before. It is clear that the advances-deposits ratio is still much too low and a considerable leeway has to be made before the pre-war ratio, which in itself was below the traditional level, can be hoped to be reached. To attain that level, the "advances" would have to increase to £2,250 million. In other words, as the *Economist* has observed, the banks would have to finance in real terms, roughly one quarter more business than they financed in their most active pre-war years, whereas at present they are financing also in real terms scarcely one-half of what they then did.¹ Neither recent experience nor foreseeable tendencies point to any such revolutionary change. If bankers have pinned their hopes to the course of bank advances, these are not likely to be realized in the near future.

In the circumstances, "advances" have ceased to act as a stabiliser of the current earnings position of the banks; and receipts on bankholdings of government securities of all kinds will principally determine their prosperity or adversity. It is no wonder, therefore, that the banks have been obliged to intrude more and more into the government securities market. During the twelve months ending in July 1946 there has been an unprecedented growth of bank investments, surpassing even the highest record attained in war-time. Investments which had stood at £1,123 million in July 1945 shot up to £1,406 million in July 1946.² This increase superimposed upon the spectacular expansion of the war

¹ *The Economist* August 31, 1946 p. 341 (Bank Assets and Earnings)

² *Ibid.*

period has occurred just at the beginning of a period, which, looked through the classical lenses, should appear to be one of great strain for the market for government securities. Naturally a great deal of attention has come to be focussed on it. But a remarkable feature of this first post-war period in England has been a simultaneous expansion of bank deposit so much so that the ratio of investments to deposits has not been raised to any alarming level. From 23.3% in July 1945 it rose to 27.5% in July 1946 and fell to 26.8% in August 1946,¹ as against 26.7% in August 1939 and 28% on the average for 1938. It is clear, therefore, that notwithstanding the large absorption of securities, the ratio has not exceeded the pre-war level. Between August 1945 and August 1946 bank deposits increased from £4,874.5 million to £5,197.5 million. This expansion of bank deposits has, indeed, come as a surprise to many bankers. It is interesting to notice that in the last quarter of 1945 when government expenditure had been still running high, deposits fell for the first time since the war-time expansion had begun, whereas when government expenditure declined precipitately, deposits rose by 12% which was the most rapid rise ever recorded.

This simultaneous upward movement in both deposits and investments appears to be paradoxical. The explanation of this paradox is to be sought in the fact that the funds effectively secured through the "savings" channels fell faster than the borrowing needs of the government; and the government had to borrow residually from the banks.² But perhaps, as the *Economist* has observed, the most remarkable feature of this remarkable first post-war year of British banking is how inextricably the banks have entangled themselves

¹ The *Economist*, *Banking Supplement*, November 16, 1946 p. 1.

² *Ibid.* p. 2.

in the gilt-edged market. This shows that by pinning their faith firmly to the future of the cheap money policy, they have allowed their portfolios to be stocked with an overwhelming preponderance of government securities, a position which had appeared to work on their nerves sometime before.

First Post-War Year of American Banking :

Turning to the banking position in the first post-war year, we are at once struck by a contrast to the English situation in several important respects. Banks in the U. S. A. were no doubt compelled to act as "underwriters to the government deficit" as elsewhere and had to finance almost the whole of the government's "uncovered deficit". But the increase in the American banks' holdings of government securities had been accompanied by a decrease in the volume of bank loans. In the case of the insured commercial banks which hold 98% of the commercial bank deposits, their holdings of government securities increased from \$21,046 million in December 1941, when America went into war, to \$88,912 million in December 1945. But during the same period bank loans had increased from \$21,258 million to \$25,765 million. The greater part of this increase had represented loans for purchasing or carrying securities. Since the end of 1945, however, there has been a remarkable reversal of this trend. There has been a continuous and progressive reduction of securities held by the banks. Their holdings fell from \$88,912 million to \$82,977 million during the period December 1945—June 1946.¹ At the same time the impact

¹ The *Economist*, Banking Supplement, November 16, 1946, p. 4 ("U.S. Banks in Reconversion").

of industrial reconversion in the U. S. A. led to a definite recovery during 1946 in typical commercial bank loans as distinguished from those secured by the collateral of securities. At the end of September 1946 commercial and industrial loans of all insured commercial banks amounted to nearly \$3 billion more than at the beginning of the war, the bulk of the increase having taken place since July.¹ This sharp increase in commercial loans has been accompanied by similar increases in real estate and consumer loans. In marked contrast, loans to brokers or to others for purchasing and carrying securities have declined mainly as a result of the increase in January 1946 from 75% to 100% in the margin requirements, which meant the prohibition of any new advances. This increase in typical business and real estate loans and decrease in security loans are the most striking changes in the loans portfolio of American banks in the period under review. Thus the first half of the first post-war year witnessed an interesting reversal of the familiar war-time trends. This upward movement of commercial loans hand in hand with a decline of bank holdings of securities was accentuated in the second half of the year.

The most important single factor that has influenced the course of American banking developments during this first post-war year is the Treasury's debt retirement programme. The retirement programme during March 1—October 1, 1946 involved the large amount of \$34,127 million, of which \$17,480 million were redeemed for cash and \$16,647 exchanged for new certificates. This heavy repayment of public debt affected the banking position in the U.S.A. in three important respects. First, it brought about a large decline in bank

¹ *Federal Reserve Bulletin*, October 1946, p. 1102.

investments in government securities. Secondly, it imposed a drain on bank reserves and thereby acted as a brake on further expansion of bank credit. Thirdly, it reduced the amount of short-term Government securities held by banks and thereby discouraged the shifting by them from short to medium term securities which in the previous period had proved to be a principal source of credit expansion.¹

In order to appreciate fully the impact of this substantial retirement of public debt upon the banking and credit situation, we have to study carefully how the bank reserves have been affected. What effect will be produced upon bank reserves will depend upon, first, whether the securities were held by commercial banks, Reserve Banks or non-bank investors and secondly, whether the securities were redeemed out of the cash resources of the Government held as deposits with commercial banks. As a result of these debt redemption operations, government accounts with the commercial banks which stood at \$23,740 million at the end of 1945 were reduced to \$12,941 million in June 1946. Thus a deflationary effect was produced upon government deposits with commercial banks which was compensated by the increase in their other deposits, partly as the result of the redepositing of cash by holders of redeemed securities and partly as the result of increased borrowing from the banks. If the government debt repaid were entirely held by the commercial banks, the monetary situation would not have been affected at all. The commercial banks were under no obligation to maintain reserves against "war loan accounts" or government deposits; and the net effect of the redemption operations would have been

¹ *Federal Reserve Bulletin*, October 1946, p. 1088.

“self-cancelling.”¹ The total reserve balances and required resources of the commercial banks as a whole remained unchanged. But individual banks lost reserve funds as the result of war loan deposit withdrawals not offset by redemption of securities held by them. In some instances, several banks had to sell government securities or borrow with a view to meeting the loss of funds.²

Federal Reserve Banks themselves were holders of some of these redeemed securities. The cash redemption of such securities involved a transference of reserves from commercial banks to Federal Reserve Banks and a corresponding reduction of their reserve balances with the latter. Thus excess reserves of member banks which stood at \$1,439 million at the beginning of 1946 were reduced to \$792 million by the end of August 1946.³ The Reserve Banks endeavoured to counteract this drain on member bank reserves and the consequent contractionist pressure on the credit situation by open market purchases but hardly with any effect. Thus the result was that the basis of reserve balances on which the entire superstructure of credit rested was considerably narrowed and money rates tended to harden.

The same effect on required reserves was produced when securities held by non-bank investors were redeemed. It brought about a shift of deposits from reserve-exempt war loan accounts to “reserve required accounts” of individuals and businesses. The amount of reserves which member banks were required to maintain consequently increased somewhat.

Thus the net effect of these debt repayment operations has been to tighten the reserve position and make the money

¹ *The Economist*, Banking Supplement Nov., 16, 1946 p. 4.

² *Federal Reserve Bulletin*, October, 1946 p. 1099.

³ *The Economist*, Nov. 16, 1946 p. 4.

rates firm. In the redistribution of banking assets noticed above and in the hardening of the interest rates, the first reactions of the American banking and credit position from the war-time trends are noticeable.¹

Indian Banking in the First Post-War Year :

A striking feature of Indian banking developments in the first complete post-war year December 1945—December 1946 is the tendency for a speedy change-over to the pre-war pattern of assets, with advances tending to occupy a prominent place in bank-balance sheets. Investments, especially those in government securities, are still important but they do no longer hold the same dominant position in the balance-sheets as they did a year or two before. Advances and bills discounted of scheduled banks which had stood at Rs. 327.19 crores on 28 December 1945 increased to Rs. 465.18 crores on 27 December 1946, *i.e.*, by Rs. 138 crores. nearly.² Although nearly 97% of this increase in advances and bills has been covered by expansion in deposits, the proportion of advances to total liabilities improved from 34.3% to 43.8%. Figures relating to investments are not available but the *Commerce* estimates that these declined from Rs. 504.81 crores to Rs. 495.72 crores.³ During 1944-45 there was an increase in the item amounting to Rs. 40.08 crores as against a decline of Rs. 6.09 crores in the period under review. The ratio of investments has registered a perceptible decline from 53% to 46.6%. This is highly significant and indicates that the familiar war-time upward trend has at least been arrested, if not com-

¹ *Federal Reserve 'Bulletin*, October 1946, p. 1099.

² *The Capital*, Indian Industries, Trade and Transport Supplement, May 29, 1947, p. 11.

³ *The Commerce*, Annual Review Number, 1946.

pletely reversed. This remarkable change in the structure of banking assets is highly significant. It implies that the banking system is no longer dependent upon the government for the outlet of its resources as it was in the recent past. This trend in Indian banking presents a sharp contrast to British banking. It will be recalled the growth of investments in the case of British banks has been larger in the first post-war year than in any year in war-time. They were as deep in the "official pie" as at any time before the end of the war. They were unable to avoid it, thanks to Dr. Dalton's relentless pursuit of cheap money policy, and the dominance of the Treasury over the bank as a consequence increased still more. In India the reverse had happened. Banks were growing less and less "residuary custodians of the public debt." As this tendency began to get stronger, the weaker became the influence of the Treasury over the banking system. This explains the failure of the drive for cheap money to affect the Indian banking system to the same extent as it did in England. Although the Government in India were able to borrow at low rates of interest, the benefits of cheap money, as it will be presently shown, have not percolated to the other sectors of our economy.¹ Business men had to pay higher rates for their commercial borrowing in 1946 than in the two preceding years. In the last quarter of 1946, indeed, there was a strong tendency for interest rates to harden, a feature reminiscent of the American situation. The cause of this hardening of interest rates is to be sought in the increasing pressure of demand for banking accommodation. But whatever might have been the cause, it is clear that the

¹ Presidential Speech of Sir C. D. Deshmukh, Governor, Reserve Bank of India.

effects of cheaper money have failed to penetrate through the fabric of banking accommodation to the business man.

In the period under consideration advances and bills discounted have increased faster than deposits. They have suddenly leapt up to the foremost place in the structure of banking assets, and a quick return to the pre-war classical pattern is indicated. The main cause of this increase is to be sought in the change over from war-time to ordinary peacetime conditions. Trade and business activity increased in many spheres as the government withdrew from these at the end of the war. This resumption of private business coupled with the cessation of "progress payments" stimulated the demand for banking accommodation. Expansion of overseas trade is reflected in an increase in "bills discounted" which at the close of the year were twice as much as a year ago. A large amount of bank credit must also have been needed for acquiring the war-time surplus stores of the government which have been estimated at several crores of rupees.

But perhaps the most important factor which has accounted for the rise in advances and bills is the all round rise in the price structure, particularly of industrial raw materials, such as raw cotton and jute, and of imported goods whose value has increased much, beyond the pre-war level. Two other important contributory factors for the rise of advances should also be mentioned. One is the large immobilisation of funds in commodities due to wagon shortage and deficient transport. The other is the granting of increased facilities against stocks and shares which had fed the speculative boom on the stock exchange to a considerable extent. A large portion of these advances, however, is

likely to have been recalled on the eve of the crash and replaced by ordinary commercial advances. It must however, be emphasised that industrial reconversion or expansion has not accounted for much of this increase in advances so far. Another notable departure from the familiar war-time trend is to be found in the continued increase in bank deposits in spite of a marked fall in the rate of currency expansion. The same paralled movement in currency and deposits which could be witnessed in war-time has disappeared. Thus the net increase in the volume of money in circulation in the period under consideration was a little above Rs. 36 crores only while deposits increased from Rs. 952.8 crores in December 1945 to Rs. 1,061 crores in December 1946 *i.e.*, by Rs. 108.1 crores. The pace of currency expansion had inevitably slowed down as a result of the sharp drop in the gigantic war expenditure of the government but the stimulus given to credit expansion by the war-time forces had not spent itself out.

Perhaps the most important factor which has contributed to this post-war expansion of deposits is to be found in the flow of hoarded money from individuals to banks, the increase, thanks to imports, in the aggregate volume of goods, the drive against the black market and the efforts to bring black money to the surface. The relaxation of controls made it unnecessary to maintain large cash balances in hand which secret dealings would have otherwise required. Among other factors contributing to deposit expansion, we may mention particularly the improvement in savings, the return of confidence among the public and the consequent disappearance of preference for liquidity. This is particularly reflected in the rise in time deposits from Rs. 280.26 crores to Rs. 330.96 crores, the highest so far in the history of the

scheduled banks. The rise in demand deposits is still greater. These increased from Rs. 672.57 crores to Rs. 730.16 crores. Nevertheless the substantial increase in time deposits year after year has resulted in a greater conformity to the pre-war pattern of deposits. The ratio of time deposits to total deposits which was about 43% in the pre-war days had declined to 24% in December 1943 but is now tending to approach the pre-war norm and has recovered to 31.19% as against 29.41% a year before. This is calculated to impart greater stability to the banking system and lessen its vulnerability.¹ It is by the observance of sound practices like this in the conduct of their affairs that bankers can stimulate healthy trends.

Although deposits have maintained their upward trend, the pace of expansion has been much slower relatively to that in previous years. The net increase in deposits during the year under review was Rs. 108.29 crores as against Rs. 134 crores in 1945, Rs. 160.91 crores in 1944 and Rs. 212.00 crores in 1943.

The cash ratio for the year is the lowest for the past five years and a half, the average for the year being 12.3 as against 13.64 for 1945-46, 14.96 for 1944-45 and 16.73 for 1942-43 but the ratio is still appreciably higher than the pre-war average of 9.80. This coupled with the fact that their investments are high and consist mostly of government securities which the Reserve Bank has declared that it would take up at market rates has considerably increased the liquidity of the banks.

¹ *Reserve Bank of India Bulletin*, March 1947, p. 127.

CHAPTER IX

THE FUTURE OF THE INTEREST RATE

The future of the interest rate is a question of vital concern for bankers in the post-war world. In England, the U. S. A., and India as elsewhere, government securities occupy such a predominant position in the assets of the banks that the post-war trend of the interest rate has an important bearing on their financial position. If the trend were downward or if the rate were pegged at the current level, the bankers would be protected against loss that would otherwise arise from a depreciation of their investments. But if the rate of interest were to rise and the decline in the values of government securities were to be serious, the banks might incur severe losses. Admittedly if the bankers had distributed the maturities of their securities carefully,—if they had chosen for the bulk of their investments papers maturing within a very few years and had generally avoided longer-term bonds,—they might be insured against such losses to some extent. Thus the American banks are protected to some extent against post-war depreciation of their assets as, it will be recalled, nearly 60% of their holdings of Government securities will mature within five years and only 14% within ten or more years.¹ But the quality of the securities chosen and the careful distribution of maturities can not by themselves ensure full protection. Prospects of low interest rates have to be assured in addition. It is worth while, therefore, to attempt a careful study of the probable course of the post-war interest rate.)

¹ E. A. Goldenweiser "Commercial Banking after the War" Article in the *Federal Reserve Bulletin*, September 1944, p. 872.

(One of the most remarkable facts in the financial history of the War of 1939 has been the continued prevalence of low rates of interest in almost every belligerent country. In sharp contrast to the first World War, Governments have pursued policies of cheap and plentiful money during the second. In spite of the extraordinary demands for war finance governments have been able to maintain interest rates at a low level, indeed at a level which is far lower than was ever attained during the War of 1914. The rise in interest rates witnessed in almost all belligerent countries during that war was due to the fact that the apparatus of control was not only imperfect but it was also intermittently applied. During World War II the machinery of control, both physical and financial, came to be perfected and highly developed. By the allocation and direction of labour and materials, by rationing of civilian consumption and by restriction, or even virtual prohibition, of new capital issues, capital development for non-essential purposes was kept down to the minimum. Governments came to acquire what was practically a monopoly on their capital and money markets and this enabled them with the help of the credits furnished by the central banks to dictate the terms on which they borrowed.¹ The result was a low level of interest rates. That such low interest rates should have prevailed in a period of acute commodity scarcity, rising prices and rapidly increasing share values is one of the paradoxes of the War of 1939-45. It is well known money rates of interest usually shoot up under the pressure of actual or apprehended inflation. Owing to the physical controls, monetary funds were generally unspendable except for purchasing securities ; and owing to the financial controls, the

¹ *Fifteenth Annual Report of the B. I. S.*, p. 140.

spendable funds flowed into the market for equities and therefrom tended to overflow into the market for debts, forcing up their prices and pressing down interest rates.¹ Apart from these factors, the fall in interest rates was in accord with deep-seated facts and tendencies. As the *World Economic Survey* has observed, "Since in war economy savings are applied to a purpose whose productivity is zero, it is natural and desirable that the interest rate should be as close to zero as possible."²

The advantages to the State of low interest rates are well known. The benefits occur because low interest rates become immediately effective for current borrowing and regarding outstanding securities as soon as they could be converted.

Monetary and central banking authorities in various countries have declared their intentions of continuing cheap money policies even after the war. As early as April 1943 the British Chancellor of the Exchequer spoke thus: "Not only shall we pass from war to peace with interest rates at a low level but the country is expecting that reconstruction and development after the war will have the benefit of cheap money. It is the government's intention to maintain its present policy of cheap money after the war for that purpose as well as in the interests of the Exchequer itself."³ The President of the Reichsbank⁴ of Germany was also reported to have made a pronouncement on similar lines.⁴ The case for continuing a cheap money policy in the post-war era was ably stated by the Governor of the Bank of Canada in

¹ *World Economic Survey*, 1939-41, p. 114.

² *Ibid*, p. 118.

³ *Fourteenth Annual Report of the B. I. S.*, 1944, p. 249.

⁴ *Twelfth Annual Report of the B. I. S.*, p. 16.

February 1944 : "The Bank should by reducing its rate signify its intention to continue the kind of monetary policy which has brought about the current level of interest rates. . . . High borrowing costs would hamper new investments in plant, equipment and housing, would restrict the expansion of employment and would seriously complicate the task of government financing. There can be little doubt that the easy money policy which has been pursued since 1935 assisted in promoting recovery from the depression and facilitated the adjustments which have been required during the war period. Indications that the Bank intends to continue this easy money policy should be helpful in making plans for the future."¹ Assurances regarding the continuation of the pre-war trends towards lower interests are also to be found in the British White Paper on Employment published in May 1944. The post-war budget speeches of the British Chancellor of the Exchequer and the Indian Finance Member have also envisaged the continuation of the same cheap money policy. Even before the war had ended, steps had already been taken in England to provide for a continuation of the war-time trends of the low interest rates in the post-war period. It was recognised that a scramble between the various competitors of capital, central government, local authority and industry, should be carefully avoided. The demands made by all these parties on the capital market should be co-ordinated in such a manner that they were made at the times and by the methods most conducive to general interests. It was proposed in a memorandum of the British Treasury to the local authorities that the latter should centralise their borrowings through the Local Loans

¹ *Annual Report of the Bank of Canada, 1943.*

fund which would be provided by the Treasury with the necessary financial resources raised on the credit of the central government. Some such technique may be followed by the Government of our country to enable the financing of post-war capital expenditure in a cheap and orderly manner. In the field of private economy downward adjustments were also made to bring into line the rates of interest prevailing in its different sectors. Rates for new mortgage loans were reduced in 1944 by the Agricultural Mortgage Corporation and the largest of the London Building Societies. Rates were similarly lowered in Germany also.¹

The British Government's drive for cheaper money in the post-war years became yet more vigorous after the assumption of office by the Labour Government. Its achievements have been so spectacular and its influence upon the whole financial structure has been so powerful that it is well worth while to examine the highlights of the technique used by the Chancellor of the Exchequer to implement his policy. The first tactical move made by Dr. Dalton was to batter the outlying defences of the structure of interest rates by intervening in the short money market. The rate on Treasury Deposit Receipts was reduced from $1\frac{1}{8}\%$ to $\frac{5}{8}\%$ with effect from 22nd October 1945. There was an immediate corresponding decline in the allotment rate for treasury bills offered at the weekly tenders. Similar movements took place in other short money rates. To recoup a portion at least of their prospective loss of income, the banks also reduced their rates paid on short-term and notice deposits and stopped paying any interest on current accounts from 30th November 1945.

But an assault on the outlying defences was not considered

¹ *Fourteenth Annual Report of the B. I. S.*, p. 189, pp. 251-52.

to be enough for the success of the policy. It was essential that the inner defences also should collapse. In other words, intervention was not to be confined to the short loan market but was to be extended to the long-term market as well. Indeed in his interim Budget speech of October 23, 1945 the Chancellor made it clear that he was exploring the possibility of attacking "the second line defences of the main gilt-edged structure."

But it was realised that any attack on the yield basis for medium or long-term securities would have to proceed, first, *via* the short bond market ; and this was the technique that came to be employed. By announcing that the "taps" for certain short-dated bonds would be turned off and by calling for redemption some other short-dated stocks, a clear warning was given that in the future even the longest dated bonds would not be yielding 3%. In the next few months the device of floating debt borrowing with the consequent increase in the supply of money was adopted to overcome the resistance of investors. Throughout this period the market was continually tested by successive issues of long-dated corporation or other semi-giltedged stocks at rates below 3%. The "small" savings structure was not left unassailed and defence bonds earning 3% were replaced by new issues of 2½% bonds.¹ Then at last the final attack on the main gilt-edged structure was launched. The market had already been prepared for it by the creation of a superabundance of funds against floating debt finance. The stage was finally set for a progressive "unfunding" of the national debt.

An important question, however, is whether the authorities would at all be able to project the pre-war and war-time

¹ The *Economist*, November 16, 1946, p. 3 ("Cheap Money in Retrospect").

era of cheap money on to the scene of post-war economy, inspite of their desire to do so. Ever since the policy of cheap money was adopted by Great Britain in 1932, it has come to attract a great deal of attention not only as a solution of budgetary problems but also as a stimulant to trade recovery and employment. The policy no doubt served to force down the rate of interest and also promoted recovery from the 1929 depression to some extent. But in the closing years of the period when a substantial measure of recovery had taken place, it became increasingly difficult to maintain low interest rates. Large borrowers were often required to line up in a queue as it were so that the terms of borrowing might not be disturbed beyond the possibility of restoration.¹ In the post-war years when the demand for capital for reconstruction purposes will be on an unprecedented scale, when heavy repairs and replacements of plant held back by the war so long will become urgent, when run down stocks will need replenishment, conditions will arise which will make it extremely difficult for the unbroken spell of cheap money to be continued.² (The long reign of cheap money can continue uninterrupted only on the supposition that a sufficient volume of savings will be available to cope with the enormous demand for capital. If there is an abundant supply of genuine savings despite heavy post-war taxation, capital need not have to be rationed between different uses and rates of interest would very probably remain low without any special intervention, provided of course the general price level does not continuously move upward.³ During the war high rates of savings have been witnessed in the U. S. A. and the United

¹*The Statist*, August 29, 1942.

²*Twelfth Annual Report of the B. I. S.*, p. 16.

³*Fifteenth Annual Report of the B. I. S.*, p. 144-45.

Kingdom. But the future is particularly uncertain in this sphere. The peace-time behaviour may be quite different from the war-time trends. There would no longer be in operation the self-restraint and special incentives of war-time. Many outlets for spending, which were shut off, would no longer be so. Taxation and particularly death duties may have their restrictive effects on savings. Hence special steps may have to be taken to obtain an assured supply of savings in the post-war years.

The difficulties of the situation are aggravated because the enormous demand for capital noticed above will occur in a world of acute capital shortage. Even apart from war conditions, Mr. Colin Clark argued on *a priori* grounds in his *Economics of 1960* that an era of prolonged capital shortage was likely to begin from 1945. 'The pressure to repair war damage and reconstruct will, therefore, be strong and insistent just at the moment when the world will be threatened with an acute scarcity of real resources. Unless the borrowing requirements of the government were subordinated to the needs of trade and industry, the two will clash much to the detriment of national interests. But the governments of every country are determined to go ahead with highly expensive and much too ambitious schemes of social betterment which should perhaps have awaited the full restoration of the productive economic life of the nations.¹

It should be remembered in this connection that the rate of interest is not merely the price paid for the use of loanable funds. It functions, as well, as a capitalisation factor determining the value of capital assets and further, as a factor influencing under normal conditions the direction of produc-

¹ *The Statist*, August 29, 1942.

tions. In a war economy profits are kept down by heavy taxation and the priorities of production are determined by the needs of the state. In the post-war economy of a serious capital shortage coupled with heavy demands for capital goods, if the rate of interest were to be pegged and assigned a merely static rôle without being allowed to arrange the order of priorities for satisfying these demands, the alternative will be the continuation of war-time controls of capital investment and priorities.¹

There is another consideration which tends to fortify the case for the projection of rigid war-time controls into the post-war economy in the event of the continuation of a cheap money policy. If the government were to peg the interest rate at a low level or were to push it further down in the post-war years, the banking system would be required to purchase large blocks of government securities. But such purchases could be possible only if the banks were provided with ample cash balances as they were during the war. But there would arise the very difficult problem of reconciling the existence of continued surplus cash reserves with a high level of employment and business activity. The twin policies of credit expansion and full employment can be permanently reconciled without provoking a vicious spiral of inflation only with the aid of a machinery of physical and financial controls almost as rigorous as in war-time.¹ /

In spite of the obvious fiscal benefit to the state from a cheap money policy, there has been some recent reaction against much too low rates of interest. This reaction is the outcome of a widely held belief that low interest rates might

¹ *The Economist*, December 26, 1942.

² *The Statist*, October 27, 1945, p. 911.

discourage savings and might adversely affect life insurance companies, social funds, university endowments and, through a narrowing of interest margins, the banking system.¹ Money rates and "margins" may be of more importance to the discount market than the banks to-day. Nevertheless the influence of money rates has been clearly discernible in the declining profits of the British banks after 1931. The influence of cheap money has indeed been cumulative as the more highly rated loans and investments were paid off and substituted by new loans or investments at reduced rates.² The narrowing of interest rate margins also pressed heavily on bank profits in Germany and was responsible for the rationalisation movement among them. But it may be replied that the loss from depreciation of assets consequent on a rise in the interest rate would be much more serious. It is interesting to note that in many countries to allay such fears as had been expressed above, assurances were given that further declines in interest rates were not contemplated.³ To encourage small savers, an increased remuneration coupled with the advantage of tax exemption was also provided in some countries.

To the uncritical admirers of a cheap money policy, it must be pointed out that a rise in interest rates has an important function, that of acting as a check upon post-war inflation.⁴ It is well known that the dangers of inflation are particularly great in the immediate post-war period, when the pent-up purchasing power of several years will be let loose almost in a flood to satisfy the hitherto postponed demand for capital and consumption goods. Theoretically,

¹ *Twelfth Annual Report of the B. I. S.*, p. 15.

² *The Bankers' Magazine*, August 1945, p. 83.

³ Cf. An official statement made in Germany in July 1941 and a memorandum on monetary policy from the Directors of the Riksbank of Sweden in 1941.

the check through taxation, as Mr. Hicks observes, would be ideal but there may be political difficulties of increasing taxation among a war-weary nation, wanting to relax a bit with the cessation of hostilities. If the rate of interest were allowed to rise, as it did after World War I, the capital value of the business firms will depreciate. To cover these capital losses, a portion of the profits earned out of war-time inflation would have to be set aside. Again, business men would be able to realize their investments only at a loss and would consequently be deterred from sacrificing them. Both these factors would restrict to a considerable extent the amount of spendable funds business men could get into their hands and thus hold the inflationary forces in check.¹

The interest method, though a highly effective check upon inflation, would clearly be a costly check. Once interest rates go up, they tend to persist at the high level for some time. In the circumstances the burden of the National Debt would be increased and private industrial activity would be hampered. It would probably be advisable for the belligerent nations to place less reliance upon the interest rate in the future than in the past. That would, however, make it particularly difficult for their governments to combat post-war inflation.²

While recognising the desirability of maintaining a cheap money policy in the interest of governmental borrowing and as a means of stimulating investment in the various private sectors of the country's economy, it must be observed that its practical application in the different countries and the tempo of its progress have to be carefully adjusted to their peculiar economic conditions. As Sir C. D. Deshmukh, Governor of

¹J. R. Hicks etc., *The Taxation of War Wealth*, (2nd Ed.), p. 17.

²J. R. Hicks etc., *The Taxation of War Wealth*, (2nd Edition), p. 19.

the Reserve Bank of India has pointed out, the wisdom of continuing cheap money policies in economically backward countries like India to the same indefinite extent as in the more advanced industrial economies of the west is to be doubted.¹ In the former the percentage of savings to total national income and the total available savings for investment are proportionately smaller than in the latter. The enforcement of a given rate of interest will need a much greater degree of interference with the market forces and will also call for a much more rigorous system of controls, but in the loosely-knit economy of such countries, it will be extremely difficult to maintain such controls. In India it is well known how lax the administration of the controls was in war-time, which inevitably had to face charges of corruption and inefficiency from the public. If it was so under war conditions, the case for continuing, multiplying and intensifying controls does not at all appear to be strong in ordinary peace-time. Even in the Western countries, especially those that are intolerant of controls and regulations and pin their faith to a policy of free and private enterprise, there is already a reaction against further lowering of interest rates. In the U. S. A., indeed, a tendency for the rates of interest to harden is to be witnessed even now.

In India, no doubt, the cheap money policy for the government has met with a fair measure of success. The rates of interest on government borrowing both long and short-term have been steadily lowered. The Government have been able to raise nearly Rs. 200 crores at 3% and have seized the opportunity for planning the conversion of 3½% undated Rupee paper and for floating subsequently the 2½% 1961 loan.

¹ Presidential Address of Sir C. D. Deshmukh at the Twelfth Annual General Meeting of Shareholders, August 1946.

But as already pointed out, the benefits of cheap money have not filtered down to the business and agricultural sectors of our economy to the same extent.

Moreover the repercussions of the prevalent cheap money policy on the country's stock exchanges and security markets have to be taken into careful consideration. It will be recalled that the most potent cause of the recent stock exchange boom was the continued pursuit of cheap money policy. In the present peculiar inflationary conditions of India, the further continuance of the cheap money policy, unrelieved by increased production and investment, is likely to intensify the inflationary forces. In these circumstances while suggesting no reversal of the present trend, we should hesitate to push down further the rates of interest. The limits to which the rates of interest may be pushed down without impairing the soundness of the country's financial and economic structure have possibly been reached. Our efforts, to quote the eminent Governor again, should be better directed towards consolidating the progress that has already been achieved.

(The unfunding operations of the British and Indian Governments in pursuance of a desire to maintain a cheap money policy, referred to above, raise a very interesting issue. If the government are determined to embark upon a systematic process of unfunding rather than of funding the accumulated debt, they would inevitably be drawn into increasing floating debt finance. So long as the government are prepared to face a mounting floating debt, the natural limits to a cheap money policy can be prevented from being reached for a long time ; and interest rates would go down.' In his Budget Speech of April 9, 1946 the British Chancellor of the Exchequer categorically stated that he did not regard the

then floating debt of £6,500 million as much too large in relation either to the total of the internal debt or the scale of national expenditure and revenue or to future requirements. Most of this debt cost the British Exchequer only one half of one per cent. and Dr. Dalton saw no pressing reason for replacing it by more expensive forms of public borrowing at that stage. The aim of the government was to cheapen money and lower interest rates to the greatest possible extent.¹ But how far should they be reduced? It is debatable, as the *Economist* has observed, whether the whole game will be worth the candle.²

¹ The *Economist*, November 16, 1946.

² The *Economist*, April 13, 1946, p. 602.

PART THREE
BANKING REFORM

CHAPTER I

BANKING LEGISLATION

Recent discussions of banking reform have principally centred round the twin problems of regulation by law and complete nationalisation. A third and altogether novel approach to banking reform which attracted a great deal of attention in the immediate pre-war years, at least in one country, *viz.*, the U.S.A., is to be found in the so-called "Hundred Percent Reserve Plan." This approach occupies the middle ground between self-policing and outright nationalisation. Under it the commercial banks will be allowed to continue in private ownership but will be made to undergo a radical change in their functions. Thus we find that the aim of legal regulation is to bring the commercial banks more and more under state control and supervision, but preserve at the same time their private ownership: while that of nationalisation is to bring them in addition under complete public ownership. But "the hundred percent plan," while not seeking to impose state ownership, does not propose to go so far as to leave the banks entirely under self-regulation. We shall be particularly concerned in this study with the question of banking legislation and that with particular reference to India. Only a brief incidental reference will be made to the political issue of nationalisation of commercial banking.

There was a time when bankers used to be advocates of self-policing policies and frowned upon any attempt to regulate and restrict their activities by law. But self-policing, it has

been frankly recognised, can be defended to-day neither on logical nor on empirical grounds. In the case of countries, particularly where banking development is yet in its infancy and banking traditions are far from being established, self-regulation is clearly out of the question. As a recent writer has put it, the question in such cases is not whether there should be regulation by law but how far and in what direction that regulation should go.¹

Special legislation aiming at regulation of commercial banking activities, which was exceptional and unusual before World War I or even in the years immediately after it, became the rule after the depression. In Germany (Law of Dec. 1934 and Decrees of February and July 1935 and June 1936), Belgium (Decrees of July, August and November 1935) and Switzerland (November 1934 and Decree of February 1935), the most notable legislative measures were enacted. In several other countries a thorough revision of banking laws was effected. On the inauguration of central banking systems, the British Dominions and the Argentine passed detailed regulations relating to commercial banks. The United Kingdom, France and the Netherlands were the most significant exceptions in this respect. In spite of the wide disparity of the conditions leading to the passage of this post-depression banking legislation, there are a large number of features which exhibit a remarkable similarity. Three factors must have been responsible for this striking resemblance. First, through affiliations and amalgamations, banking units increased in size to an unprecedented extent and began to cultivate much closer relationships with trade and industry. In the circumstances the banking system and hence the

¹ L. L. Watkins, *Commercial Banking Reform in the United States* pp. 398-399.

country's national economy became exposed to much more serious risks in the event of a financial crisis. Secondly, the lesson of the 1931 crisis was clear that "mixed banking" was extremely undesirable in the existing structure of banking. Lastly, where central banking systems were being inaugurated for the first time, a co-ordination between central and commercial banking policies had to be ensured.¹

Although there has been an under-current of feeling in India that the Companies Act touched only a fringe of the problem of banking legislation and although the question of legislation had engaged the attention of the Government long ago, nothing appears to have been done in this direction till 1936. In that year when the Companies Act was amended, a few sections (Secs. 277F-277N) were incorporated in that Act which would be applicable specifically to banking companies. But the provisions have been widely regarded as much too inadequate and there has existed for several years a keen popular demand for a full-fledged Banking Act which would protect the Indian bank depositor in the same way in which the Companies Act and the Insurance Act, both now suitably amended, are protecting the stock-holder and the policy-holder. This popular demand for a separate Banking Act gathered momentum after the failure in 1938 of the Travancore National and Quillon Bank, when public attention came to be focussed on the very questionable methods on which a number of the smaller banks in India were conducted. In a memorandum to the Directors of the Central Board, Reserve Bank of India, dated the 9th June, 1939, the then Governor, Sir James Taylor, stressed the desirability of a Banking Act for India, and outlined his proposals for such

¹ *Money and Banking*, 1937-38, Vol. I (League of Nations), pp. 92-93.

legislation.¹ These proposals formed the basis of the Draft Bank Bill of 1939 which was circulated by the Government of India at the request of the Reserve Bank for eliciting public opinion. Owing to the war developments, however, it was decided to postpone for the time being the consideration of comprehensive legislation and to adopt instead some urgent interim measures designed to improve the administration of the law relating to banking companies.

In October 1942, Sec. 277F of the Companies Act relating to the definition of a banking company was amended as an interim measure. Under it, any company using the word "bank," "banker," or "banking" as part of its name would be deemed to be a banking company irrespective of whether the business of accepting deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order was its principal business or not. Certain other proposals of the Reserve Bank of India were also incorporated in the Indian Companies (Second Amendment) Act, 1944 which received the Governor-General's assent on the 7th March, 1944 with a view to removing the undesirable features observed in the capital structure and management of banking companies floated since the outbreak of the war. Under this Act, a bank is prohibited to employ a managing agent or any other person whose remuneration or part of whose remuneration takes the form of a commission or a share in the profits of the Company or any person having a contract with the Company for its management for a period exceeding five years at a time. The following further restrictions have been imposed upon banking companies incorporated after 15th January, 1937.

¹ *Memorandum to the Directors of the Central Board dated 9th June, 1939.*

1. The subscribed capital should not be less than half the authorised capital and the paid-up capital not less than half the subscribed capital.

2. The capital of the company should consist of ordinary shares only or ordinary and such preference shares as were issued before the commencement of the Indian Companies (Amendment) Act, 1944.

3. The voting rights of all shareholders should be strictly in proportion to the contribution made by the shareholders to the paid-up capital.

More recently the Reserve Bank reviewed its original proposals for banking legislation made in 1939 in the light of subsequent developments and experience and submitted to the Government a revised draft of a comprehensive Bank Act with a request to proceed with the necessary legislation as early as convenient. Accordingly on the 16th of November 1944, a bill was introduced into the Legislative Assembly for consolidating and amending the law relating to banking companies. This bill embodying mainly the essential features of the 1939 bill, but making a departure, healthy and progressive in some respects but unwholesome and retrograde in others, was the Banking Companies Bill of 1944.

The rapid growth of banking resources and of the number of banks and their branches in war-time impressed upon the authorities the urgent need of a separate legislative measure for the regulation of Indian banking. There was another factor which further strengthened the case for taking immediately into hand a separate comprehensive Banking Law. That was to be found in the increased vulnerability of the banking system in the post-war period by reason of the

war-time increase, both absolute and relative, of demand deposits as against time deposits.

The bill was in due course referred to a Select Committee which should have met in October 1945, but before the Committee had considered it, the bill lapsed. Another bill based on the previous measure of 1944 was introduced in the newly elected Legislative Assembly on the 15th March, 1946. In the light of the opinions and criticisms received on the earlier bill, certain modifications were introduced in this Bill, which were in some respects an improvement on the former. But the Bill in substance was the same as that of 1944 and was not free from defects altogether. There was still plenty of scope for improvement. The Bill was referred to a Select Committee and the Report of the Committee together with the Bill as amended by it was presented to the Legislative Assembly on the 17th February, 1947. It is worth while to examine in detail the more important provisions of this Bill in the light of the amendments proposed by the Select Committee, with a view to find out how far the purposes envisaged generally under contemporary banking legislation, and particularly under the Indian measure, would be achieved through them.

As a recent report of the Bank for International Settlements has well observed, current banking legislation as adopted in various countries has pursued the twin objectives of ensuring improved liquidity and a more clear-cut separation between commercial and investment banking functions.¹ In the case of the proposed Indian legislation, the statement of objects and reasons declares that its primary object is to safeguard the interests of the bank depositor. The Hon. Sir Jeremy Raisman observed in the Assembly that a second-

¹ *Eighth Annual Report of the Bank for International Settlements.*

any objective was to ensure the development of banking along sound lines.¹ Some of the provisions in the Indian Bill when it was first introduced in 1944 aroused the keenest of controversies and were subjected to the sharpest criticisms. Without plunging ourselves in the welter of controversies but steering clear of them, we shall be chiefly concerned in focussing our attention on those provisions of the Bill of 1946 which are designed to attain the objectives outlined above, the safety of the depositors and the liquidity of the banking system. The question of the safety of the depositor is closely bound up with that of the liquidity of the banks and this question of liquidity, again, is inter-twined with that of the intermixture of banking functions. The main features of the proposed legislation have to be examined, therefore, from the standpoint of how far the relevant provisions are calculated to protect the interests of the depositor by improving liquidity and restricting "mixed banking." The question of how far the sound development of banking will be promoted will also be studied incidentally.

In India the problem of banking legislation is beset with peculiar difficulties. Banking is an indigenous activity of long standing in the country and has developed along its own lines. It has its own instruments for the transfer of value and recording of obligations. In the circumstances, as Sir James Taylor in his memorandum and Sir Jeremy Raisman in the Legislative Assembly pointed out, it is not merely a question of applying models which might be suitable for other countries. In framing a Banking Act for our country, therefore, the most careful and anxious consideration has to be applied to its peculiar conditions.

¹ *Legislative Assembly Debates*, Vol. V, November 1944, p. 1045.

Broadly speaking, the concept of bank liquidity may be viewed from two aspects, long and short-term. The first aspect, long-term liquidity, relates to the question of ultimate protection to the depositor in the event of a liquidation. The concept of short-term liquidity, which must be carefully distinguished from the first, may be further analysed into 'normal' and exceptional liquidity. The former implies ability to meet normal withdrawals of cash and the latter sudden and exceptional demands for cash in an emergency. Banking legislation as such does not aim at the protection of the bank shareholder. There is the ordinary company law to look after his welfare. The primary purpose of such legislation is to safeguard the interest of the depositor. In attempting to achieve this purpose, banking legislation, though seeking to promote ultimate liquidity to some extent, is chiefly concerned to ensure the liquidity of commercial banks in this narrow restricted sense of their ability to satisfy the sudden and heavy demands of their depositors for cash in emergencies. In this sense, as Mr. Sayers has aptly pointed out, the concept of bank liquidity has two distinct attributes—ability of the banker to convert his assets into cash : (1) quickly and easily and (2) without loss. The speedy conversion of the assets into cash would not by itself ensure true liquidity. A great deal of the assets may be so converted, *i.e.*, easily shifted on to other shoulders, but not without a considerable depreciation of their values. It is essential, therefore, that the assets in order to be truly liquid must possess the twin attributes of "shiftability" and "risklessness". A further refinement may be made of the concept of shiftability which in the ultimate analysis resolves into 'shiftability' on to a Central Bank. In the circumstances, the liquidity of commercial banks is closely bound up with the liberality or

otherwise of the eligibility canons of the central bank of the country in question.¹

The principal methods through which banking legislation in various countries has striven to secure bank liquidity are minimum requirements of capital and reserve, statutory cash reserves, regulation of the type of banking assets, maintenance of minimum liquid assets and segregation of investment from commercial banking functions. It is widely recognised, however, that the liquidity provisions should not be too detailed and meticulous so as to fetter unduly the discretion of the banks nor too austere and rigorous so as to arrest a sound and healthy banking development of the country or to deprive trade and industry, particularly small businesses, of their legitimate needs of credit.

¹ R. Sayers, *Modern Banking*, pp. 112-18.

CHAPTER II

THE INDIAN BANK BILL OF 1946—AMENDMENTS PROPOSED BY THE SELECT COMMITTEE

Clause 11. (*Capital Standard*) :

An adequate capital structure is believed to impart strength to commercial banks. Banking legislation recently adopted in various countries has sought to secure adequate capitalisation in three principal ways : (1) by prescribing a legal minimum capital (as in Belgium, Norway and Canada) (2) by correlating the capital (and reserve) to the deposit liabilities (as in Switzerland and the Argentine) and (3) by linking capital to the population of the place in which the bank is operating (as in the U.S.A.). Combinations of these methods are also not unknown. Under Section 277 I of the Indian Companies (Amendment) Act of 1936 a statutory minimum capital was provided for the first time for Indian banks. Clause 11 of the Bill of 1946 as of the Bill of 1944, dealing with capital standards appears to combine (as in the case of the 1939 Draft Bill) the first method of a statutory minimum with the third one of linking capital to a population basis. The capital requirements were (1) a minimum of Rs. 1 lakh for any banking company (2) Rs. 20 lakhs, if the banking company had a place of business in India outside the province in which it had its principal place of business or if it had its principal place of business in an Indian State (3) Rs. 5 lakhs in respect of a place of business in Bombay or Calcutta (4) Rs. 2 lakhs in respect of each town other than Bombay and Calcutta, having a population of over 1 lakh

(5) Rs. 10,000 in respect of each place of business elsewhere (a feature absent from the 1939 Bill) (6) an over-riding minimum of Rs. 20 lakhs.

The need for some regulation of capital of the commercial banks must be frankly recognised. The history of bank failures not only in India but also elsewhere (particularly in the U.S.A. during the 1931 crisis) has clearly shown that the incidence of mortality has been heaviest among the smaller banks. During 1934-43 669 banking companies in India were liquidated or wound up, most of which had very poor banking resources. Of the 48 banks liquidated or wound up in India in 1942, only four had a capital of Rs. 50,000 or more ; of the 50 in 1943, only three had such capital. But it remains to be seen, first, whether the prescribed minimum as well as the method of prescription would be really suitable under the peculiar Indian conditions ; and secondly, whether minimum capital requirements do really promote "liquidity" in the sense in which we are using the expression.

The bare provision of a fixed minimum capital as was laid down in the Companies Amendment Act of 1936, would clearly be unsuitable in a country like India where banks differ widely in size and importance. Under this system depositors of the larger banks would not be afforded the same degree of protection as those of the smaller banks. From this point of view, the combination of this method with the population basis in the Bill of 1946 was undoubtedly an improvement. The mere provision of the population basis, again, would have the effect of rendering a bank in one of the largest cities hopelessly undercapitalised. The procedure adopted was, therefore, to require Indian banks in the two principal cities to be equipped with larger minimum capital

than banks elsewhere. The same practice is to be witnessed in Japan and in some sense also in Italy.

In many quarters the fixing of a proportion between the capital of a bank and its deposits has been considered to be a more satisfactory method of securing adequate capitalisation and protecting the interests of the depositor. The higher the capital-deposit ratio, the smaller, it is urged, will be the risks of the depositors. "It is a mathematical certainty," observes a writer in a recent issue of the *Statist*, "that the risks of depositors increase at an accelerating rate with every diminution in the ratio between capital and deposits." The question of linking capital to deposits was raised and discussed at some length in the Indian Legislative Assembly with regard to the Bank Bill of 1944. On behalf of the government it was contended that the fixing of a proportion between capital and deposits was open to two serious objections: first, frequent changes in share capital would be inevitable under it and secondly, banks would be saddled with the heavy burden of a large share capital owing to the prevailing quantum of deposits and the expanding post-war economy.² The capital-deposit ratio has developed into such an important standard of banking supervision in recent years that it is worth while to examine how far it serves as a suitable guide to supervisory policy—how far it is a proper measure by which capital may be judged ample or inadequate.

The ratio between the capital and deposits has usually been fixed at 10% in the countries which have adopted this method. But there does not appear to be any scientific basis for this 10% ratio. It has probably been adopted because it

¹ *The Statist*, British Banking Section, May 27, 1944, p. 5.

² Mr. Ram Nath (Govt. Official), *Legislative Assembly Debates*, Vol. IV, No. 8, 11 April 1945, p. 2785.

is a good round decimal easy to calculate. There are several considerations which, however, tend to make the capital-deposit standard quite a misleading guide to capital requirements and hence to supervisory policy. One of the most serious defects of the capital-deposit ratio lies in its failure to distinguish between the differences in the composition of the assets of the various kinds of banks. Banks operating in the rural areas and bearing the undiversified risks of local agriculture and industry are not nearly so liquid as those in the money markets, having considerably diversified earning assets of far smaller credit risks. The capital protection adequate for the latter type of banks expressed as a percentage of their deposits would be hopelessly inadequate for mofussil banks. In the second place, it must also be borne in mind that the character of bank assets and constituents of bank portfolios change between periods. In such circumstances a drop in the capital-deposit ratio would not necessarily indicate that the banks have grown weaker. From the limited evidence which is available it does not appear that this ratio, at least as based on book values, was indicative of banking difficulties. The depreciation of assets was a better index. In the circumstances it may be urged that assets provide a more reasonable guide to capital requirements, and as a guide to supervisory policy, the capital-assets standard would be more appropriate than the capital-deposit ratio. It would further provide a more direct and effective control over bank investment policies. Under the capital-deposit standard the need for more capital may be indicated just at the moment when the banks would be under the greatest difficulty to raise it, that is, when deposits increase and idle funds fast accumulate and bank profits are decreased. There is, however, an objection that may be urged against the capital-assets ratio as

a supervisory standard. It is that it would tend to inhibit bank investment in the early and middle stages of business recessions. But this is a charge which can be made with equal emphasis against the other alternative. The assets standard for judging the adequacy of bank capital may raise some administrative difficulties. Differences among bank assets varying according to the degree of risk have to be recognised, and differential rates of capital requirements for various classes of assets have to be fixed. But this is perhaps not an insuperable difficulty. A minimum capital-assets ratio of 10% would be a more appropriate supervisory objective than the outmoded capital-deposit ratio of an equivalent amount.¹ In the case of the Indian banks the method of fixed minimum capital coupled with the population basis which has been adopted by the government is undoubtedly more appropriate than the capital-deposits standard as securing an adequate capital structure. But the capital-assets standard would have been still better.

Now the question is whether the size of the capital prescribed and the population basis of the capital are at all suitable for India under the present stage of banking development in the country. The minimum of Rs. 1 lakh does not appear to be unreasonably high in view of the present monetary situation which has been radically altered since 1939. The disaster that recently overtook some well-known banks, operating with inadequate capital resources beyond the frontiers of their own province or state, has no doubt promoted the adoption of the population basis of the capital structure as well as the prescription of a minimum of Rs. 20 lakhs for

¹ Art by R. I. Robinson in *The Journal of Political Economy*, February 1941, Vol. XLIX entitled "The Capital Deposit Ratio in Banking Supervision," pp. 41-53.

banks functioning on an inter-provincial or state-province basis. If the banks were operating over the entire area on an All-India basis, there would be nothing to quarrel with these provisions. But this assumption is true only of the larger institutions having a network of branches all over the country. Medium and small banks would be severely handicapped under these provisions. Such banks in the mofussil towns and rural areas would be unable to open branches in the larger cities. Further, as the *Eastern Economist* has pointed out, an anomalous position would be created by the legislation in as much as a bank operating in one district in one province desirous of opening a branch, in the natural and legitimate course of its business in a contiguous district in another province, would be debarred from doing so unless it could satisfy a capital requirement which was almost prohibitive for it.¹ This is not merely a theoretical possibility but is very real in the case of border districts of every province and would produce incalculable harm. The absurdity of the whole position was clearly brought about by Dr. P. N. Banerjee in the Central Assembly when he pointed out that a bank could be established in Delhi City with a capital of Rs. 2 lakhs but if it were desirous of opening a branch at Ghaziabad which was fast becoming a suburb of Delhi it would, at once, have to provide Rs. 20 lakhs.²

The statistics relating to the size of capital and reserves of Indian banks are of particular interest in this connection. In 1943 there were only 92 banks having a paid-up capital and reserve of Rs. 5 lakhs and over, 152 banks between Rs. 1 lakh and Rs. 5 lakhs ; and 141 banks between Rs. 50,000 and Rs. 1 lakh. In 1942 banks having a paid-up capital and reserve

¹ *The Eastern Economist*, January 12, 1945.

² *Legislative Assembly Debates*, Vol. IV, No. 8, 11 April 1945, p. 2773.

below Rs. 50,000 numbered 133.¹ The small banks, at any rate a fairly large number of them, occupy an important position in India's national economy. They have been catering all these days for the financial needs of small business in the mofussil as well as in the cities. As it has been pointed out by a recent writer, these smaller banks cover two-thirds of the banking map of the country and are responsible for banking facilities in as many places as are covered by the bigger banks and they claim as many offices and branches.² Operating in a narrow sphere, they know their locality and their customers well. Their managers freely form invaluable social contacts outside their formal business relations. Under the Bill of 1946 the small banks will find it difficult to open branches in the big cities and may have to confine their activities to the mofussil. In that case the principal sources of credit facilities for small urban traders and business men will disappear. If, however, the banks choose to open branches in the cities, they will have to increase their capital and will find themselves over-capitalised in relation to their deposits.

The Government spokesman in the Legislature assured us that the special position occupied by the smaller banks in the national economy of our country and the part played by them in financing trade and agriculture were fully recognised by the Government. There was no intention, indeed, to hinder and hamper them. "The proposals were designed with the opposite object of helping and guiding them, in the conduct of their operations on sound lines in order that they may be able to take their proper place in the agricultural and indus-

¹ *Statistical Tables relating to Banks in India and Burma*, 1942 and 1943.

² S. K. Muranjan, *Modern Banking in India*.

trial reconstruction of the country in the post-war period.”¹ But it is difficult to see how the disaster would be averted.

The idea behind this clause in the bill appears to be the regulation of branch banking and prevention of overtrading by small banks. The minimum of Rs. 50,000 prescribed by the Indian Companies (Amendment) Act of 1936 for banks incorporated after the 15th January 1937 is much too low not only as compared with many other countries but also in the present monetary situation in India. Banks with inadequate capital resources are springing up like mushrooms at every street corner in the big cities and towns. This concentration of banking offices in a few cities and towns stands in sharp contrast with the dearth of banking facilities in the mofussil. These undesirable trends would no doubt be restricted to a considerable extent by Clause 11. But it is debatable whether branch banking can not be regulated more effectively than by the fixation of a high capital standard. Branch banking may perhaps be better controlled and the purpose envisaged in this clause be more effectively realized, if a licensing system more or less on the lines of that adopted in the German Credit Act of 1934 were to be introduced. Any bank wishing to do banking business in India or an existing bank wishing to open or close a branch may be asked to take out a licence, which is renewable every year, from a suitable authority, say, the Reserve Bank or a Banking Commissioner. The granting of the license should be made to depend upon the possession of sufficient capital to carry on business in India, upon adequate professional qualifications and standing reputation and integrity of the directorate, and upon local and general considerations. Such a licensing

¹ *Legislative Assembly Debates*, Vol. IV, No. 8, pp. 2785-2786.

system would not only enable the authorities to insist upon a restriction of the scope of its business or in alternative an increase of capital but would also pave the way for a planned development of banking within the country, stimulating a systematic expansion in under-banked regions and restricting further extensions in overbanked areas. This is of particular importance in the context of the present rapid expansion of branch banking in the country. The regional distribution of banking facilities, as Sir Homi Mody observes in his recent Presidential address, has been very uneven. While the Punjab, Madras, Bombay and the U. P. have accounted for 60% of the total additions to branches, Sind, Baluchistan and Assam have continued to be neglected.¹

It is not suggested for a moment that there is no need for legal stipulation of an adequate capital structure. Even if a licensing system were adopted, the authorities in estimating the financial position of the banker would have to fall back upon some such rule as is generally laid down in banking laws. It is only meant to draw attention to the inevitable result of throttling small-scale banking enterprise and to impart some measure of flexibility in place of the rigid fixation of the capital limit, irrespective of the peculiar conditions in the country and the different types of business carried on by different types of banks. A large number of the smaller banks have been fulfilling important functions for several years past not without satisfying the canons of sound and efficient management. They are an integral part of our economy and should not be indiscriminately wiped out. Indeed they may have to be preserved in many instances against the sweeping competition of the bigger banks. The

¹ *Annual General Meeting of the Shareholders, Central Bank of India Limited, 1946.*

question has assumed a special importance in the present times owing to the rapid rise of banks which have taken advantage of the prevailing monetary conditions to start with a large capital structure. The potential threat to the smaller banks is serious.

Select Committee's Amendments :

The population basis which came in for a good deal of criticism has happily been replaced in the Select Committee's amendment by a more elaborate but more workable basis. Except that the addition of Rs. 5 lakhs to capital is retained in respect of places of business in Calcutta and Bombay as contained in the 1946 Bill, the population basis has been abandoned. Its place is now taken by a new basis dependent on the territorial range of a company's activities introducing the region (to be coterminous with the Reserve Bank's share register areas) above the province. In the case of a banking company having its principal place of business elsewhere than in British India, according to the new clause 12, the paid up capital and reserves should not be less than Rs. 15 lakhs plus Rs. 5 lakhs if it has a place of business in Calcutta or Bombay city or both. In any other case, *i.e.*, in the case of banks having their principal place of business in British India, subject to the addition of Rs. 5 lakhs in regard to places of business in Calcutta or Bombay, a banking company should have a minimum capital and reserves of (a) Rs. 10 lakhs, if it has places of business in more than one "region"; (b) of Rs. 5 lakhs, if it has all its places of business in one region but not in one province. If it has all its places of business in one province and has no place of business in Bombay city and Calcutta, it should have a paid up capital

and reserve of Rs. 1 lakh in respect of its principal place of business plus Rs. 10,000 in respect of each other place of business in the district in which it has its principal place of business plus Rs. 25,000 in respect of each place of business situated elsewhere in the province ; but the banking company shall not be required to have more than Rs. 5 lakhs in the aggregate. The Select Committee have retained the one lakh minimum but have made one exception. A small banking business operating with only a single office will be required to have only Rs. 50,000. But if it desires to open even one branch, this exceptional minimum must be more than doubled. If a bank has all its places of business in one province and has one or more place of business in Bombay city or Calcutta, it shall have Rs. 5 lakhs plus Rs. 25,000 in respect of each place of business outside Bombay city or Calcutta, subject, however, to a maximum of Rs. 10 lakhs. Branches outside the region or province of a bank but within 25 miles of its principal place of business will now be regarded as falling within the region. It will be seen that the Select Committee in laying down the capital standard for a banking company has adopted a combination of three principles—the importance of metropolitan cities such as Calcutta and Bombay, the territorial range of a bank's activities and a minimum absolute amount. The amendments relating capital to the territorial range of a bank's activities instead of to population will, it is hoped, be a more satisfactory method of ensuring capital structure. The latitude extended to branches outside the region or province of a bank but within 25 miles of its principal place of business will serve to correct the anomalous consequences to which a bank, as pointed out above, would have been subjected under the original bill of 1946. Further, the exception made by the Select Committee in favour of a small banking business

running only one office, which will henceforth be required to maintain a minimum of Rs. 50,000 only, will be helpful to the small banking companies.

Clause 18 (*Licensing of Banks*) :

The question of a licensing system for banks in India has engaged the attention of economists and publicists for a long time. It came up before the Central Banking Enquiry Committee of 1931 who recommended that banks would be called upon to take out licenses from the Reserve Bank of India when such an institution was established. This was partly necessary in the interests of the depositors and partly for giving the Reserve Bank some measure of control over the banks operating in the country.¹ When the Government circulated the original "Proposals for an Indian Bank Act" in 1940, they also received suggestions from many quarters that a system of licensing foreign banks doing business in India should be introduced. The demand for a licensing system for foreign banks has been insistent here for a long time, particularly in view of the fact that discrimination in some sense or other is practised against non-national banks in several countries, some of which are even commercially far advanced. It is only those countries where the local banks are powerful and well-organised that the need for such protective regulations has not arisen. When Indian opinion has sought to place restrictions upon foreign banks, it has been moved not by a spirit of retaliation or racial discrimination but only by a desire to ensure the orderly development of Indian banking.² Local banks are neither so strong nor so

¹ *Report of the Indian Central Banking Enquiry Committee*, p. 456.

² Cf. The Minute of Dissent by Mr. N. R. Sarker and *The Minority Report* by Mr. Manu Subedar.

well-organised as to dispense with the need of protection at this stage against the powerful foreign competitors. The Banking Enquiry Committee, however, had not been inclined to impose any restrictive regulations which would smack of discrimination and recommended that the licenses should be issued freely. Clause 17 of the original Bill of 1944, which had no counterpart in the Draft Bill of 1939, provided for a system of licensing which was half-hearted and clearly unsatisfactory. Only banking companies, which were not incorporated in British India or the United Kingdom and were not carrying on business at the commencement of the Act, would have to take out a license before commencing business or opening a branch after the Act came into force. It is satisfactory to note, therefore, that Clause 18 of the 1946 Bill which corresponded to Clause 17 of the 1944 Bill sought to introduce a comprehensive system of licensing of banks by the Reserve Bank of India. As the clause stood, it provided for licensing of all banks with the provision that scheduled banks, except those whose country of origin discriminated in any way against British Indian banks, were exempted from the obligation to take out a license so long as they remained in the schedule. Foreign banks, even though scheduled, whose country of origin discriminated against British Indian banks, and existing non-scheduled banks could carry on business but they must comply with the requirements and obtain the requisite license from the Reserve Bank within five years. The granting of the license would be conditional, first, upon the maintenance of a sound financial position which might be ascertained by an inspection of the banking company and secondly, in the case of foreign banks upon whether their country of origin did not discriminate against British Indian

banks.¹ Although this feature of the 1946 Bill was welcomed, it was not free from the same grave objection that had been urged against the original bill. Banks incorporated in British India and the United Kingdom were grouped together as if the latter were not foreign institutions. This amounted to positive discrimination in favour of the British banks which were treated far more generously than the banks incorporated in the Indian States. It was also not clear why licensing should not immediately come into operation instead of after five years from the commencement of the Act.² There was another important defect. Although disabilities were being imposed on foreign banks, there did not appear to be any restriction on foreigners starting banks in our country. A new sub-clause (6) was added to provide for the licensing of the opening of branches so as to prevent indiscriminate expansion of bank branches. Before opening a new branch, the Reserve Bank's previous sanction must be obtained in writing and the Bank in sanctioning the application might require to be satisfied that the public interest would be served thereby. Attention has already been drawn elsewhere in the book to the indiscriminate and lopsided growth of branch banking in war-time in our country. The desirability of putting a brake on such unhealthy expansion is unquestioned. But instead of the vague ground that it was against public interest, certain rational and clear-cut standards must have to be observed in regulating the growth of branches.

It is satisfactory to find that the Select Committee were convinced that all banking companies should be required to take out licences and saw no reason for granting exemption

¹ See *Memorandum explaining the changes made in The Banking Companies Bill*, L-A-Bill No. 26 of 1944, Gazette of India, March 22, 1946, p. 58.

² *The Eastern Economist*, May 3, 1946, p. 720.

to the existing companies for so long a period as five years. Clause 18 has been redrafted and the new Clause 21 provides that every existing company must apply in writing to the Reserve Bank for a license within six months from the commencement of the Act. Every new company before it starts business must also similarly apply for a license. Existing companies may carry on until the Reserve Bank grants or refuses to grant a license. Before granting any license under this section the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that all or any of the conditions given below are fulfilled.

(1) That the company is in a position to pay its deposits in full as their claims accrue.

(2) That the affairs of the company are not being conducted to the detriment of the interests of the depositors.

(3) That in the case of a company incorporated elsewhere than in British India or the United Kingdom, the government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in British India and that the company complies with all the provisions of this Act, applicable to banking companies incorporated outside British India.

The provisions contained in sub-clause (b) of the old Clause 18 referred to above have been taken to a new clause *viz.*, Clause 22. The draft follows the recent banking companies (Restriction of Branches) Act, 1946 (which will now be replaced) but an exception has been provided for the opening of temporary branches not exceeding one month to cater for the needs of conferences, exhibitions and melas.

Clause 14 (*Reserve Fund*) :

Following the practice elsewhere the provision of a legal minimum capital has not been considered to be sufficient and in the Bill of 1946 a reserve fund was required to be maintained in the case of the non-scheduled banks. Under Clause 14 which corresponded to Clause 13 of the Bill of 1944, such banks should build up a reserve fund by setting aside at least 20% of their profits before declaring a dividend until the fund equalled the paid-up capital.

The specification of the percentage of net profits to be carried to the reserve fund until it reaches a stated ratio to capital is a notable feature of most banking legislation. The minimum proportion of net profits to be carried to reserves is found to range from 5% in Turkey and Switzerland to 22% in Norway ; and the maximum limit of reserves to capital to be reached varies from 20% in Switzerland and the U.S.A. to 200% in Roumania. The position in the different countries in this respect is indicated in the table given below.¹

Country	Minimum proportion of yearly net profits to be carried to reserves.	Maximum compulsory limit of the ratio of reserves to share capital.
	• %	%
Norway	.. 20	50
Sweden	.. 15	50
Argentina	.. 10	50
Bolivia	.. 10	25

¹ *Money and Banking*, (League of Nations) 1937-38. Vol. I, p. 96.

Country	Minimum proportion of yearly net profits to be carried to reserves.	Maximum compulsory limit of the ratio of reserves to share capital.
	%	%
Bulgaria	10	100
Chile	10	25
Colombia	10	20
Ecuador	10	25
Japan	10	100
U. S. A.	10	20
Roumania	5	200
Switzerland	5	20
Turkey	5	100

The provision in the Indian legislation appears to be the most stringent regulation of its kind in the history of contemporary banking legislation save the Roumanian. The minimum proportion of yearly net profits to be carried to reserves is the highest except that in Norway with which it is equal. But the maximum compulsory limit of the ratio of reserves to share capital is there only 50% against the Indian 100%. In Roumania, again, the minimum percentage of net profits to be carried to reserve is only 5% against the Indian 20%.

It must be observed in this connection that the strength of a commercial bank does not depend upon the size of the reserve fund but upon the form in which the fund is maintained. Curiously enough, banking legislation, though meticulous as regards its size, has seldom specified the types of

assets in which it should be invested. In the circumstances in an emergency it has been found to be hardly less frozen and immobilised than capital and deposits and therefore, for all practical purposes, useless for ensuring the liquidity of commercial banks and protecting the interests of their depositors. There are only two or three instances where banking laws have stipulated the manner in which the reserve fund should be held. In Belgium the whole of it has to be held in the form of public or government guaranteed securities and in Bulgaria a certain portion of it has to be maintained as a deposit with the National Bank.¹ In Poland joint-stock banks are obliged to invest at least 50% of their reserves in first class securities.² Some such stipulation, it is interesting to notice, existed in the Indian Companies (Amendment) Act of 1936 providing that the reserve fund must be invested in government or trustee securities or deposited with a scheduled bank. The omission of some such requirement must have robbed the obligation to accumulate a reserve fund of much of its significance and value.

Neither the capital nor the reserve fund can be regarded as a factor contributing to the "liquidity" of the banks in the sense in which the expression is understood here. They tend to secure long-term liquidity and afford protection to the depositor in the event of the bank's liquidation. The capital is a guarantee fund set aside by the shareholders for the ultimate protection of the depositors and other creditors of the bank. The reserve fund similarly acts as a cover against losses through possible depreciation of the assets in

¹ Allen, Cope and Dark etc., *Commercial Banking Legislation and Control*, p. 13.

² *Money and Banking*, 1937-38 Vol. I. p. 97.

which the reserve fund is held in the event of the winding up of the institution. Even then it must be emphasised there is no point in building up a reserve fund without requiring it to be held in the form of assets which would retain a considerable proportion of their value in times of a depression. Again, while admitting the soundness of the principle of building up reserve funds from undeclared profits, it must be pointed out that the setting aside of so high a percentage as 20 p.c. might involve the payment of small dividends over long periods calculated to impair the credit of the banks. Even in the U.S.A. which appears to have supplied the model, the percentage is not so high, being only 10 p.c. Some such percentage may be adopted for our country and the target may be 50 p.c. of the paid-up capital as in Norway, Sweden and the Argentine, instead of the proposed 100 p.c. The exclusion of the scheduled banks from the provisions of this clause was inexplicable. The defect has been sought to be remedied by an amendment made by the Select Committee. The amended Clause 17 which corresponds to the old Clause 14 has imposed this obligation to build up and maintain a reserve fund on the same scale as before upon all banking companies incorporated in India whether scheduled or not.

The liabilities of the commercial banks are essentially demand liabilities and it is frankly recognised that a certain proportion of the assets should consist of cash. In many countries statutory cash reserves bearing a fixed percentage to deposit liabilities, a higher ratio for demand and a lower one for time liabilities, have been provided with the avowed objective of ensuring the liquidity of commercial banks. Under Sec. 42 of the Reserve Bank of India Act, 1934, scheduled banks have to maintain balances with the Reserve

Bank amounting to 5 p.c. of demand and 2 p.c. of time liabilities. Under Clause 15 of the Bill of 1946 non-scheduled banks were required to maintain in cash or balance with the Reserve Bank a sum equal to at least 5 p.c. of demand and $1\frac{1}{2}$ p.c. of time deposits. The proposed amendment of the Select Committee in Clause 18 which corresponds to the old Clause 15 is that 2% will apply to non-scheduled banks just as it applies to scheduled banks. But fixed legal minima are hardly effective in promoting bank liquidity. However paradoxical the remark may appear, the higher the legal reserve ratio, the lower is the liquidity of the banks. Their strength depends not on their legal but on their surplus reserves. Thus the statutory cash reserves of commercial banks might guarantee ultimate protection to the depositors in the event of liquidation just as paid-up capital and reserves would do, but they are of limited significance as a provider of short-term liquidity, the kind of liquidity with which we are vitally concerned. It is only when the provision of legal cash reserve ratios has been coupled with the further provision of their variation in an emergency that they are of some value in enabling the banks to meet sudden and unexpected withdrawals.¹ From this point of view, the banks in the U.S.A., Mexico and New Zealand, where the ratios are flexible and in Germany and the Argentine where the observation of the cash ratio may be temporarily suspended, stand on a better footing than our scheduled banks under Sec. 42 of the Reserve Bank Act and non-scheduled banks under Clause 18 of the amended Banking Bill. It may be recalled in this connection that the primary function of flexible minimum cash ratios is not to improve the liquidity of the banks but

¹ Allen, Cope and Dark etc., *Commercial Banking Legislation and Control*, p. 67.

to furnish the Central Bank with a new weapon to control the money market. But even here, we have seen, it is debatable how far this weapon of credit control would be effective in a narrow market like India where the banks are not wedded to the practice of maintaining rigid cash ratios.¹

Clause 19. (*Liquidity Ratio*) :

The crucial section relating to liquidity is Clause 23 of the Banking Bill as proposed by the Select Committee which corresponds to Clause 19 of the Bill of 1946. It seeks to ensure the liquidity of the banks by requiring them to maintain a minimum percentage of their total deposits in liquid assets, consisting of cash, gold or unencumbered approved securities. The percentage which was 30 in the 1939 Bill and was reduced to 25 in the 1946 Bill has been further reduced to 20% by the Select Committee. The maintenance of minimum liquidity ratios either as a result of tradition or of statutory obligation is to be found in several countries abroad. British banks have enjoyed unrivalled reputation for their tradition of maintaining a fairly high liquidity ratio, which in their case refers to the ratio of cash, short loans and bills discounted to deposits. Prior to the outbreak of the war the British banks were accustomed to work round about a norm of 30 p.c. When the war broke out, the ratio was 29 p.c. Ever since the Treasury Deposit Receipts came to be included in the list of the banks' quick assets, the liquidity ratio has been soaring above the pre-war line. By August 1940 the ratio stood at 35.3 p.c. ; in 1941 it touched 40 p.c. and in September it reached a peak of 47.9 p.c. An interesting feature of this war-time development has been that the cash ratio has re-

¹ See before pp. 105-106.

mained unchanged at about 10.4 p.c. but that while the percentage of short loans and bills discounted to deposits has fallen, that of T. D. R's has steadily shot up. We have examined elsewhere the claim of the T. D. R's to be included strictly under quick assets. But the fact remains that the high liquidity ratio of British banks has given them considerable freedom to switch over from short-dated to relatively long-dated investments. It must have, therefore, speeded up the acquisition by the banks of longer-dated government securities. From this point of view the ratio of 30 p.c. in the 1939 Bill, though perhaps a little too austere for the smaller banks, must have been more useful in the context of post-war funding of war-time debts.

Sweden, Denmark, Switzerland and Germany furnish the most important instances where the maintenance of liquidity ratios is a matter of legal obligation. Cash is only one among several components of the liquid assets which are sometimes called "readily realisable" or "easily mobilisable" assets. In some instances a distinction is made between the primary or cash ratio and the secondary or liquidity ratio *i.e.*, the ratio between liquid assets (other than cash) and deposits. In Germany, for example, two kinds of minimum ratios are to be witnessed, (1) the cash ratio and (2) the ratio between deposits and "secondary reserves" other than cash. The principal components of these liquid assets besides cash are deposits with the central or other banks, gold, commercial bills, treasury bills, government, municipal and certain other kinds of securities. The ratios between these liquid assets and deposits as defined by law vary from country to country. In Sweden the ratio between readily realisable assets and demand liabilities is 25 p.c. In Denmark besides the usual ratio of cash to total liabilities, there are two other ratios,

first, a ratio between liquid assets and demand deposits amounting to 15 p.c. and secondly, a ratio between such assets and total liabilities amounting to 10 p.c.¹ In Germany the Credit Act of 1934 provided for a minimum ratio between secondary reserves and current liabilities, the ratio to be fixed by the Supervisory Board, varying according to the type of the Credit Institution but in no case exceeding 30 p.c.² The tables given below show at a glance the position in this respect in a number of countries. It will be seen that in some countries only primary or cash ratios are required to be maintained while in others the secondary or liquidity ratios have been enforced in addition. Turkey is perhaps the only country where the liquidity ratio alone is required.³

Cash Reserves as % of Deposits.

	Sight	Time or Savings	Total
Bolivia ..	20	10	..
Ecuador ..	20	10	..
Chile ..	20	8	..
Argentina ..	16	8	..
Canada ..	.	..	5
India ..	5	2	..
Denmark, Banks			
with capital of ..	3-2	..	..
5 million kronor	.		
Banks with less			
capital ..	1	..	..
Roumania ..	10	.	..

¹ Allen, Cope, Dark etc., *Commercial Banking Legislation and Control* pp. 175-176.

² *Federal Reserve Bulletin*. January, 1935.

³ *Money and Banking*, 1937-38 Vol. I (League of Nations) pp. 97-98.

Liquidity Reserves as % of Deposits.

		Sight	Time	Total
Roumania	..	33-1/3	..	..
Sweden	..	25	..	..
Norway	..	20	..	5
Turkey	..	..	15	..
Denmark	..	15	10	..
Finland	..	20	..	..
Switzerland	..	25, 30, 40 or 50	..	..
Bulgaria	..	33-1/3	..	..

First, as regards the cash ratio of the Indian banks, it will be found from the table given below that the ratios of cash to deposits in the case of both scheduled and non-scheduled banks compare very favourably with the 10% cash ratio of the British banks. As already noted, the former have been steadily mounting during the past years while the latter has remained practically unchanged in war-time.

TABLE¹

Ratio of Cash and Balances with banks to Deposits.

	1938	1939	1940	1941	1942	1943
Imperial Bank of India.	11·0	12·6	25·9	14·0	12·1	24·9
Other Indian Scheduled Banks.	14·6	17·2	23·6	18·8	23·1	23·9
Non-Scheduled Banks Class A (capital and reserves over Rs. 1 lakh. ,	12·4	12·2	18·4	20·7	28·0	32·4

¹ *Statistical Tables relating to Banks in India and Burma, 1939 and 1940, 1941, and 1942 and 1943, p. 6, p. VIII.*

Ratio of Cash and Balances with banks to Deposits.

	1938	1939	1940	1941	1942	1943
Class B (capital and reserves between Rs. 50,000 and Rs. 1 lakh.)	...	17.4	20.6	24.9	31.5	31.5
Class C (capital and reserves below Rs. 50,000.)	...	14.4	17.3	15.5	17.3	...

The liquidity ratio of the Indian banks which in their case, it will be recalled, refers to the ratio of cash plus investments at present will be found in the table given below¹:

Liquidity Ratio (Ratio of Cash plus Investments to Deposits).

	1938	1939	1940	1941	1942	1943
Imperial Bank of India.	64.6	55.9	76.5	73.1	85.3	85.6
Other Indian Scheduled Banks.	57.6	55.1	63.6	64.2	75.8	75.3
Non-Scheduled Banks, Class A.	35.2	40.4	43.9	49.6	56.7	57.3

The liquidity ratio of 20% required under the proposed amended legislation does not certainly appear, in the light of the above figures, to be much too rigorous for the Indian scheduled banks whose percentage of cash plus investments was 57.6 in 1938 and 75.3 in 1943. For non-scheduled banks Class A (having capital and reserves over Rs. 1 lakh) the figures were 35.2 in 1938 and 57.3 in 1943.

The composition of the quick assets which make up the total to be used for calculating the liquidity ratio must,

¹ *Ibid.*

however, come in for a good deal of criticism. In England such assets comprise cash, short loans and bills discounted. To these, it will be recalled, a new item has been added in recent war years, *viz.*, the Treasury Deposit Receipts which are tending to become the preponderating item. In the Continent, as we have seen, such assets are to be found in a more varied, if in a less liquid form. In India there is no short loan market in the sense in which there is one in London. For the Indian banks this avenue of liquidity is not available. In the Dominions of Australia and New Zealand where also a short loan market in the same sense does not exist, banks have adopted the practice of holding money at call or on short loan in the London market and these funds are reckoned among their liquid assets. It is not a wide-spread practice with Indian banks, however, to employ their funds in this way in the London money market. In the circumstances it is natural that Indian law should appear to be guided by Continental practice in regard to the composition of the liquid assets. But the components of such assets have been restricted to cash, gold and unencumbered securities alone, thus rendering their scope much too narrow not only in relation to the position in the Continent but also in relation to the peculiar circumstances of India. To what an extent the composition of the liquid assets as envisaged under the Bill is defective may be well illustrated by reference to the position of the smaller non-scheduled banks whose advances are principally made for financing seasonal agricultural operations. In 1943 non-scheduled banks having a paid-up capital between Rs. 50,000 and Rs. 1 lakh are found to have a percentage of loans and advances to deposits amounting to 62.5 p.c. Admittedly loans and advances are not self-liquidating like discounts and are for relatively longer period. But the seasonal character of

these advances elevates them almost to the status of short loans and provides the necessary safeguard that moneys will not be locked up for pretty long periods. They may therefore be justifiably included in the list of quick assets. As Mr. T. K. Krishnamachari pointed out in the course of the Assembly Debates, such smaller banks have 50 to 60 p.c. of their resources in cash or approved securities for about 8 months of the year but during the season 80 to 85 p.c. of their resources are employed in advances on grain.¹ The clause will have a restrictive effect on the useful functions they exercise and adversely react on the country's agricultural economy. The T. D. R's to-day are occupying the front rank in the liquid assets of the British banks but their claim to be regarded as quick assets is scarcely greater than that of the seasonal advances of the smaller banks in India. Again, whatever may be urged against the case of including seasonal advances under quick assets, there is not the slightest ground for excluding "bills discounted" as a component from the list of such assets. First class commercial bills and any other bill rediscountable with the Reserve Bank should legitimately be included under them. In 1943 the percentage of bills discounted to total deposits was 6% in the case of "other scheduled" banks and 4.34% in the case of non-scheduled banks with a paid-up capital between Rs. 50,000 and Rs. 1 lakh. It may also be pointed out in this connection that the smaller non-scheduled banks derive a high proportion of their resources from time deposits, so that liquidity of assets is not necessary for them in the same sense or extent as in the case of the larger banks. A smaller prescription of liquidity may, therefore, be suggested for such banks having a predominance of time liabilities.

¹ *Legislative Assembly Debates*, Vol. V, November 1944, p. 1056.

In evaluating the liquid position of commercial banks, attention should be directed to the ratio between their liquid assets as a whole and deposits rather than the one between cash and deposits. The ratio of advances to deposits is also a better criterion of liquidity or illiquidity than the simple cash ratio. The Australian trading banks have watched more carefully the percentage of cash, London funds and Treasury bills to deposits as well as that of advances to deposits rather than the ratio of cash alone to deposits. The liquidity ratio in the case of the Australian banks *i.e.*, the proportion of cash, treasury bills and London funds to total deposits during 1930-1936 varied between 38·5% to 21·4%. From the point of view of the percentage of advances to deposits, however, the nearly 50% ratio of the scheduled banks in 1938 is not an evidence of a highly liquid position. In war-time the decline of advances has occurred as a result of merely fortuitous circumstances and the percentage has accordingly dropped down. In the case of the smaller banks the position would appear to be still more illiquid had it not been for the fact that the bulk of the advances were made for the purpose of financing seasonal agricultural operations.

Clause 6 Sub-clause (1) (f) (g) (h) and (i) of the 1944 Bill (*Real Estate Loans and Ownership*) :

By far the most effective device to ensure a bank's liquidity by law is to define the kind of assets it may or may not acquire. Hard and fast rules and meticulous regulations regarding the permitted investments, however, would unduly fetter the discretion of the banker. Liquidity is likely to be secured more effectively by negative regulations banning the acquisition or holding of certain types of assets than by much too detailed

and positive prescriptions. An almost ubiquitous restriction to be met with in current banking legislation relates to the ownership of real estate. The regulations range from an enforced disposal of real estate acquired in the natural process of business within a prescribed period to limiting its holding to a certain percentage in money value of the bank's capital. There are also to be found restrictions upon loans against the security of real estate. American experience during the last crisis sufficiently demonstrated that investments in real estate and loans against real estate were the worst types of frozen and immobilised assets. In an article published in the Banking Supplement of *The Nationalist*, 18th March, 1945, we had severely criticised the provisions under sub-clause (1) (g) (h) (i) of the original Bill of 1944 which related to the acquisition, holding, management etc. of real estate. There did not appear to be any restrictions upon the holding of real estate nor upon loans against its security. We had urged that in the light of current trends in banking law and of the unfortunate American experience, it was desirable that some restrictions should be placed upon such kinds of business. Land is no doubt a valued form of security, especially in an old country and does not fluctuate in value as widely as in a new country. In India it may also be the only form of security that can be offered in many cases. Without suggesting, therefore, a total prohibition of such kinds of business, the confinement of such business within certain limits was stressed. The holding of property for a bank's own use might be limited to, say, 30 per cent. of its paid-up capital and reserve. All other property, if acquired as a result of foreclosure, must be sold as soon as it was possible to do so without depreciation of its value. The disposal of non-banking assets within seven years of its acquisition was no doubt provided for under Cl. 9 of the 1946 Bill.

Cl. 10 of the Bill as amended by the Select Committee lays down a corresponding provision. The Select Committee have, however, proposed that the Reserve Bank's power to extend the period for the disposal of such assets held by a bank should be raised from three to five years. But it is not clear if it is applicable to real estate as such. The real estate loans should also be restricted to a certain percentage of the bank's paid-up capital and reserve, the percentage being somewhat lower than that in the case of the holding of such estate. The percentage of immovable properties owned by "other scheduled banks" to their paid-up capital and reserve was as high as 40 in 1941. Taking advantage of the abnormal rise in prices a part has since been disposed of and the percentage fell to $33\frac{1}{3}$ per cent. in 1942 and below 20 per cent. in 1943 (about 18 per cent.). The ratio for non-scheduled banks with capital and reserve of Rs. 1 lakh and over, which was about 14 per cent. in both 1941 and 1942, however, increased to 20 per cent. in 1943.¹

It is satisfactory to notice that the force of these criticisms was not lost upon the Government. In the Bill of 1946, sub-clause 6 (1) (g) of the original Bill found no place. The explanation for the omission as supplied by the Government itself was the undesirability of allowing a bank to acquire real property as a part of its ordinary business.² But though the acquisition of property was not expressly permitted, there were still no provisions in the 1946 Bill nor any amendments have been proposed by the Select Committee aiming at a restriction of real estate loans business. Sub-clause (1) (h) and (i) also remained as before and formed sub-clause (1)

¹ *Statistical Tables relating to Banks in India and Burma*, 1942 and 1943.

² *Memorandum explaining changes made in the Banking Companies Bill of 1944*, Gazette of India, March 23, 1946 p. 86.

(f) and (g) of the 1946 Bill. They are still in the same form in the Bill as amended by the Select Committee.

Clause 6 sub-clause (1) (d) and (f) of the Bill of 1944. (*Mixed Banking*) :

Commercial banking legislation adopted recently in the various countries has pursued the two-fold objective of ensuring liquidity and curbing "mixed banking". The memory of the widespread disaster caused by the intermixture of banking functions during the crisis of 1931 in many countries was fresh in the minds of the legislators and they sought to bring about a divorcement between commercial and investment banking functions with a view to prevent a repetition of the disaster. It is interesting to notice that such separation has been sought to be achieved not only in countries where mixed banking became a new development during the crisis but also in countries which had always been regarded as the traditional homes of such banking. Perhaps the most radical legislation in this respect have been the Belgian Decrees of August 22, 1934 and July 9, 1935-37. Under their provisions the holding of shares and participations in any manner whatsoever in enterprises other than banks as defined by law was entirely forbidden. The American Banking Acts of 1933 and 1935 and the Italian Law of March 1936 were hardly less radical. The German Credit Act of December 5, 1934 was perhaps the most notable legislation, for Germany was the strongest citadel of "mixed banking". The Swedish and Colombian laws prohibiting direct and indirect participations in industrial or commercial enterprises were less striking but they had the same object in view. In a number of other countries, Bulgaria, Denmark, Finland, Norway, Poland, Roumania and the

Argentine, participations or share holdings were restricted to a stated percentage of the banks' capital, the percentage ranging from 10% in Finland to 50% in Denmark.¹ In the light of these current legislative trends elsewhere, it was astounding to find a clause like sub-clause (1) (f) in the original Bill, permitting a banking company to promote or finance a business undertaking or industry through the instrumentality of syndicates. Sub-clause (1) (d) which permitted the underwriting of and participating in managing and carrying out of any issue of shares, debentures etc. of any company was no less open to criticism from this point of view. The only provision which imposed some restriction on the investment banking operations of the Indian banks was to be found in Cl. 15 (2) under which a banking company's holding of shares either as pledgee or absolute owner in any company was limited to 40% of the issued and subscribed capital of that company. The holding, curiously enough, was not related to the capital of the banking company itself.

I have examined elsewhere the case for commercial banks going in for industrial financing and have shown that Indian banks may be permitted to embark upon that kind of business only under very circumscribed conditions.² Admittedly the liquid position of the banks engaged in long-term industrial financing is considerably impaired unless the credit policies are carefully planned and the risks well distributed. *The Eastern Economist* also takes the same view that in India it is safe to proceed on traditional lines.³ But it will be recalled

¹ *Money and Banking* 1937/38 Vol. I (League of Nations) pp. 101-102.

² See the writer's *Industrial Finance in India* and *Industrial Credit in War and Post-war Economy*.

³ *The Eastern Economist*, 19 January, 1945.

that owing to the special circumstances created by the war, opinion is gaining currency in England as well as America that a relaxation of the strict orthodox codes of banking policy is called for in the post-war period. But in no circumstances the wide scope for investment banking granted to Indian banks under the sections noted above would be justified. We are very glad to find, for we were severely critical, of these sections in the article already referred to,¹ that the Government were well advised to omit the whole of Sub-clause (1) (f) in the 1946 Bill and also the word "promoting" occurring in Sub-clause (1) (d). Clause 16 which corresponded to Clause 15 of the old bill was further amended with a view to tightening it up and making interlocking of assets still more difficult. The percentage was reduced from 40 to 20 and was correlated not simply to the capital of the company whose shares were purchased but also to the capital and reserves of the purchasing bank which ever was less.² The Select Committee have kept unchanged this proportion but have proposed that the provision should take immediate effect on the commencement of the Act and have further empowered the Reserve Bank on application to allow time not exceeding two years to companies to bring their share holdings into compliance with this provision. Banking companies have been debarred from taking up shares in another company in the management of which their own managerial staff are interested. As the extent to which banking companies can hold shares in other companies has been provided for in this section, item (j) from Clause 6 sub-clause (1) has been omitted. The Select Committee consider that the providing of safe deposit

¹ *The Nationalist, Banking Supplement*, 18th March, 1945.

² A doubtful point about the clause was whether it included or excluded debentures.

vaults and carrying out clearing and forwarding business are important legitimate activities of banking companies and in Clause 6 Sub clause (1) items (a) and (b) have been suitably amended to provide for these. But sub-clause (1) (d) remained otherwise as before and it still remains unchanged in the Bill as amended by the Select Committee. It should have been modified in the light of recent developments elsewhere. Even if the current liquid position of the commercial banks might justify their departure from the traditional practices, we have to remember the risks, cost and unfortunate experiences in the past of ventures by commercial banks in the field of long-term investment and proceed with caution, judgment and circumspection. Attention would have to be paid to the ratio of capital and reserves to deposits as well as to depreciable assets, the proportion of time and savings deposits to total deposits, the volume of the liquid as against readily marketable assets constituting the secondary reserves and the careful maintenance of a proper spacing of maturities. In particular, increase of bank capital will have to be seriously considered by bankers desirous of extending their activities in this sphere. The attitude of many Indian bankers resisting the imposition of legal minimum capital requirements but at the same time inclining towards industrial financing is inexplicable.

Clause 17 (*Restrictions on Loans and Advances*) :

A reference may be made in this connection to restrictions on loans to a single customer and on unsecured loans which are to be found in the banking laws of several countries. Clause 17 of the 1946 Bill which corresponded to Clause 16 of the Bill of 1944 prohibited the granting of loans and advances on the security of the banks' own shares and prohi-

bited the granting of unsecured loans to the banks' directors or their concerns. Although an English bank has always been inclined to advance against its own shares, banks in many countries have been prohibited to accept their own shares as security for loans either entirely or beyond a stated percentage of their paid-up capital. So far the provision was in line with current legislative trends elsewhere. But the Banking Bill provided no restrictions upon loans to a single customer nor did it prohibit or restrict unsecured advances except to the banks' directors and their concerns. Excessive and indiscriminate loans to officers, directors, managers or their interests have been fruitful causes of bank failures in the past not only in India but also in the U. S. A. and other countries. A total ban on such loans would, however, deprive the banks of the advantage of having experienced industrial magnates on their board of directors. It was, therefore, decided to place a check on loans to directors by insisting upon security. Recent legislation in Germany fixing a ceiling on the amount of unsecured loans is of special interest, for German banks had always a fondness for personal credits and used to advance, prior to 1931, large sums to industrial undertakings frequently without any security. But the new Canadian Bank Act (1944) has for the first time allowed the chartered banks to compete with money lenders and loan companies⁴ in the lucrative but dangerous business of unsecured personal loans under certain conditions.¹ In Clause 20 which corresponds to this clause the Select Committee have proposed one relaxation. The grant of unsecured loans to *public* companies, as distinct from *private* companies, in which the banking company or any of its directors is concerned, will not be unlawful. To compen-

¹ *The Economist, Banking Supplement*, 28 October 1944, p. 3.

sate for such relaxation, provision has been inserted requiring returns to be given of such loans and empowering the Reserve Bank to put a stop to this practice where it is undesirable and requiring the banking company to recall these loans.¹ The proposed relaxation has been welcomed but it will not go far enough. Loans on personal security to big industrialists are considered to be legitimate business of banking companies in many quarters. The regulation will interfere with established practices of business finance and prevent industrialists from becoming bank directors.²

Clause 39 (*Restriction on Amalgamations*) :

Clause 39 of the 1946 Bill was a new clause which had no counterpart in the 1944 Bill. It prohibited amalgamation, re-arrangement or reconstruction of a bank except with the previous sanction in writing of the Reserve Bank. The Bank's consent to any amalgamation would not be given unless it was reasonably satisfied that each of the banking companies concerned therein would be able to pay its debts as they fell due. It is continued in the Bill as amended by the Select Committee as Clause 44. But as sub-clause (2) has been drafted, most proposals for amalgamation will be ruled out. The Reserve Bank must be satisfied that the joint concern after amalgamation should be able to meet all the obligations of the previously separate concerns.² Clause 38 of the 1946 bill imposing restriction on voluntary winding up was not considered sufficient to prevent unsound companies from taking advantage, under cover of a merger, of the voluntary winding up proceedings to the detriment of the interests of

¹ *New Clause*, 20 (1), (2) and (3).

² *The Eastern Economist*, April 25, 1947, p. 746.

the depositors.¹ Clause 39, therefore, was inserted to prohibit amalgamations except with the approval of the Reserve Bank. The provisions in old Cl. 39 and new Cl. 44 are wholesome and particularly significant in the context of the rush for amalgamations that is likely to take place for meeting the minimum capital standard after the Bill has been passed. Coupled with the provisions relating to the licensing of banking companies and opening of new branches, these will enable the Reserve Bank to direct a planned and sound banking development of the country in the post-war period.

Central Bank Credit Facilities :

In discussing the concept of bank liquidity above, it was pointed out that ultimately it resolved into shiftability on to the central bank and was therefore closely related to the eligibility standards of that institution. The rediscount facilities allowed by the Reserve Bank of India to the scheduled banks as set forth in Sec. 17 (2) of the Bank Act are limited to papers arising out of bonafide commercial or trade transactions, bearing at least two names, one of which must be that of a scheduled bank and maturing within 90 days. In the case of bills drawn for financing seasonal agricultural operations, the maturity is extended to 9 months. Sec. 17 (4) permits the making of loans and advances on demand or for a maximum period of 90 days against such bills and promissory notes as are eligible for rediscount by the Reserve Bank. When the central banking system was inaugurated in this country, it was the hope and belief of the authorities that a bill market could be established and the bill habit would grow. In spite of the efforts of the Reserve

¹ *Gazette of India*, March 23, 1946. p. 90.

Bank of India neither a bill market nor the bill habit has developed. The Reserve Bank of South Africa right from its inception hardly left any expedient untried in its attempt to create an internal bill market. But all its efforts were unsuccessful. Its experience sufficiently demonstrates the difficulty of establishing bill markets in countries like India and South Africa. The English conception and the English tradition of central banking regard the bill market as the "natural habitat" of a central bank. British advisers have light-heartedly recommended the establishment of bill markets on foreign soil and banking personnel schooled in the traditions of British banking have set out to develop them, ignoring altogether the difficulties in the way of their creation. Instead of wistfully longing for the day when a bill market would be created, it is advisable now to take steps to enlarge the scope of rediscount facilities. The wording of Sec. 17 (2) has considerably circumscribed the powers of the Reserve Bank to make advances to member banks when their liquid position is strained. The situation has been further aggravated not only by the absence of an internal bill market but also by the non-existence of a system of country-wide public warehousing. In the circumstances the rediscounting facilities are few and limited and tend to impair the liquidity of the commercial banks. In the light of the recent central banking developments elsewhere, the section may suitably be amended so as to liberalise and render more flexible the rediscount facilities offered by the Reserve Bank. A reference may be made in this connection to the case of the Reserve Bank of South Africa which was empowered in 1930 to make advances not only against trade and agricultural paper eligible for discount but also against one name bills or promissory notes secured by documents of title representing staple commodities

which were fully insured and had active markets. The maturity of commercial paper was extended from 90 to 120 days.¹ It is also being increasingly recognised that at the time of a deflationary trend technical limitations on the character of eligible paper imperil rather than safeguard the banking structure.² Accordingly there is a remarkable tendency among new as well as old established central banks, to relax the traditional requirements relating to eligibility and extend the scope of their discounts and advances. The insistence on a minimum liquidity ratio without the benefit of extended rediscount facilities is an anomaly which should be removed.

It is satisfactory to note in this connection that an assurance was given by the Government spokesman to the members when the 1944 Bill was being considered by the last Assembly that the problem of increasing the usefulness of the Reserve Bank Act had been receiving the constant attention of the Bank.³ Proposals have already been circulated to provincial Governments for setting up ware-housing companies. When such companies will be established on properly constituted lines, documents of title would be created and the Reserve Bank would be enabled to furnish assistance against them under Sec. 17 (4) (d).

It is interesting to notice in this connection that the Select Committee have frankly recognised that side by side with statutory regulation of banking, the Central Bank of the country should be brought into closer contact with the ordinary banks. Accordingly they have introduced a new clause which sets out the further duties and functions of the Reserve

¹ De Kock, *Central Banking*, pp. 102-103.

² *Federal Reserve Bulletin*, October 1937, p. 979.

³ Mr. Ram Nath, *Legislative Assembly Debates*, Vol. IV, No. 8, April 11, 1945, p. 2782.

Bank of India in its relations with other banks and seeks to empower it to have full information about the working of banks and to render timely and adequate help when necessary. Thus in the proposed Clause 35 the Reserve Bank may caution any particular banking company or banking companies in general against entering into particular transactions or types of transactions ; advise them in proposals for amalgamation on request and subject to Clause 44 referred to above ; give assistance to them by means of the grant of a loan or advance under sub-section 3 of Section 18 of the Reserve Bank of India Act, 1934. The Reserve Bank shall also make an annual report to the central government on the trend and progress of banking in the country with particular reference to its activities under clause (2) of Sec. 17 of the Reserve Bank of India Act 1934, including in the Report its suggestions, if any, for the strengthening of banking business throughout the country.¹

Another important provision is to be found in the new Clause 53 proposed by the Select Committee. It amends sub-section 3 of Section 18 of the Reserve Bank of India Act whereby the Reserve Bank will be enabled to go to the assistance of banks, under certain circumstances, by means of loans and advances secured to the Bank's satisfaction by forms of security other than those permitted at present. Under the proposed amendment the power and discretion of the Reserve Bank will be considerably widened in the matter of giving financial aid to the ordinary banks. It should be welcomed as remedying an important shortcoming. The significance of this amendment will be appreciated in the context of the recent banking crisis in Bengal, during which

¹ Clause 35 (1), (2) and (3) *Gazette of India*, March 1, 1947, p. 167.

the Reserve Bank could take only such steps as were permitted under the Act to aid the banks. But under the Act the Bank had nothing to do with non-scheduled banks. At a reception given by representatives of non-scheduled banks to Mr. Mechkri, Deputy Governor of the Reserve Bank of India, at Calcutta, he disclosed that the Bank was approaching the Government of India for amendment of the Act in such a way as to enable it to render assistance to non-scheduled banks, provided they had tangible assets on the basis of which advances could be made. The new clause together with the amendment of Sec. 18 of the Act as proposed by the Select Committee will fill an important lacuna and help to avert a serious banking crisis in future. But the non-scheduled banks should direct their efforts to keeping their assets in a liquid form, instead of "playing with them" and to producing assets in the shape of goods.¹

Inspection : Clauses 30 and 45.

It has not been contemplated to set up a separate inspectorate or banking commission on the lines of similar bodies elsewhere. But the Reserve Bank has been charged with considerable initiative and responsibilities which it shares with the Government.

Clause 30 of the 1946 Bill providing for bank inspection corresponded to Clause 28 of the original Bill which proved to be one of the most controversial clauses in the Assembly Debates, and was subjected perhaps to the heaviest barrage of criticisms. Under it the Reserve Bank was to be directed by the Government to inspect a banking company, its books and accounts and make a report to the Government when

¹ *The Statesman*, December 20, 1946.

the latter believed that the interests of its depositors were in danger or the banking company was unable to meet its obligations or had made default in complying with any provision of the Act. The Government might prohibit the bank from receiving fresh deposits and direct the Reserve Bank to apply for its winding up.

The provision in the original bill [Cl. 28 sub-clause (2)(b)] under which the Central Government would direct the exclusion of the bank from the Second Schedule was incorporated in a new clause, viz., Clause 45, which sought to amend Sec. 42(6) of the Reserve Bank of India Act. The power to include or exclude a bank from the Second Schedule which rested with the Government was to be conferred by the amendment upon the Reserve Bank.

In contemporary banking legislation as many as four different types of control may be distinguished, according as the control is exercised by the State, an independent controlling body originating in the banks themselves, banking commissions of mixed bodies and the Central Bank. Of these the most familiar type is the first. The control and supervision are exercised either directly by the State, as by the Comptroller of Currency in the United States, or by special organisations nominated by the State and remaining subject to its decisions. Control is thus exercised by the *Superintendencia bancaria or de banco* in some of the Latin American countries on behalf of the Finance Minister or by Inspectors deriving their powers from the Crown in the Scandinavian countries and by inspectors subordinate to the Finance Minister in Finland, Poland and Canada. In Germany supervision was exercised both by an office of control and a Reichskommissar. As for the last type of control, the Central Bank is not usually vested with powers of supervision and control over the banks,

although it is well represented in the supervising body, the Governor being its President. In South Africa, New Zealand and India (up to the present times), the central bank, however, exercises such official control as is statutorily provided.¹ In the U.S.A. the Board of Governors of the Federal Reserve System exercise a substantial and strict measure of control over the member banks. In Belgium and Switzerland we witness banking commissions of mixed bodies but they are not empowered to inspect the banks directly which function is entrusted to chartered accountants.

Clause 30, as it stood, was open to two serious criticisms. In the first place, it provided for fitful and irregular inspection—a procedure which was likely to discredit the bank concerned in the eyes of its clientele. The bank would be exposed to serious risks of a run if the Reserve Bank got the government permission and instituted inspection whenever it felt that such inspection was necessary.² A regular and periodical inspection of all banks should be substituted for the proposed procedure, and the Reserve Bank should create a special department for the purpose. As early as 1939 the Bank had admitted the necessity of creating such a department with the progressive development of banking in the country.³ It is high time that the department was opened. In the second place, the initiative as regards inspection should be left wholly with the Reserve Bank rather than with the Government as contemplated. When the power to include a bank in the schedule or to deschedule it was being transferred under the new Clause 45 from the Government to the Reserve Bank on the ground that the Reserve Bank as the Central

¹ *Money and Banking*, League of Nations 1937-38, Vol. I, pp. 103-4.

² *Legislative Assembly Debates*, April 6, 1945, p. 62.

³ *The Eastern Economist*, January 19, 1945, p. 62.

Bank of the country was the appropriate authority for undertaking this responsibility, especially in view of its experience of inspections of banks and intimate contact with them, it was an anomaly that the Government should still give a directive to the Reserve Bank. It will be recalled that Clause 4 (3) of the recent measure nationalising the Bank of England, under which the Bank could "issue directions" to any banker with the authorisation of the Treasury, encountered a storm of opposition from several quarters as being much too drastic and far-reaching.¹ There was a strong and widespread feeling in the City that the initiative for "request" and "recommendations" should originate with the Bank as has been the established practice, and not with the Government.²

The Reserve Bank was endowed under Clauses 30 and 45 with a very large measure of control over the ordinary banks. There did not appear to be any provision for allowing the banks an opportunity to offer an explanation of their conduct. When the affairs of a banking company were considered to be conducted in a manner detrimental to the interests of its depositors, it might deschedule the company even if it satisfied the minimum capital and reserve requirements or might report to the Government and, with its sanction, prohibit it from accepting fresh deposits or even demand its winding up. The report might also be published by the Government. It is clear, therefore, that direct action or threat of it was envisaged under the proposed Bill. Powers of qualitative control could have been statutorily vested in the Reserve Bank, if in addition it could suspend a commercial bank from the use of its credit facilities whenever in its judgment it was making undue use of central bank credit.

¹ See before, pp. 67-72.

² *The Economist*, October 13, 1945, p. 514.

Such powers of controlling the quality of credit with a view to restrict the use of central bank credit for speculative purposes were conferred upon the Federal Reserve System by the American Banking Act of 1933.¹

We are indeed very glad to find that the Select Committee have appreciated the force and logic of our criticisms as made above and have attempted to meet some of them by suitable, re-drafting of the sub-clauses of the old Clause 30 which has now become Clause 34. To prevent a dangerous loss of public confidence which was sure to ensue if inspection were to be authorised only when the affairs of a bank were considered to be unsound, sub-clause (1) has been recast so as to give the Reserve Bank free discretion to inspect a banking company at any time. In such circumstances the public will have no ground for drawing any pessimistic inference from the mere fact of inspection of a bank.

Thus the Reserve Bank may carry on an inspection either on its own initiative or at the direction of the government. In all cases a report will be sent to the banking company concerned which may be given an opportunity by the government to make representations in connection with the report. The government may prohibit the banking company from receiving further deposits, direct the Reserve Bank to apply for its winding up, impose such conditions on it as they consider fit and also finally publish the report submitted by the Reserve Bank either wholly or in part.

New Clauses relating to Bank Management [Cl. 11 (c) and (d) and Cl. 12 (3) (d)].

Frankly recognising that the best security for deposits

¹ Art. by R. B. Westerfield in the *Journal of Political Economy*, December 1933, p. 736.

consists in sound and honest management, the Select Committee have introduced several new provisions relating to the duties and responsibilities of the directorate and management. In order that the staff of a banking company may devote their whole time to the service of the company, the Committee have provided that no bank shall employ or be managed by a person who is a director of any other company not being a subsidiary company of the banking company or who is engaged in any other business or vocation. [Cl. 11 (c) and (d)].

A second form of control imposed on the banks' directorate is to be found in Cl. 12 (3) (d) where it has been provided that the voting rights of any one shareholder shall not exceed 10% of the total voting rights of all the shareholders. The case for such a provision rests, according to the Select Committee, upon the manifest undesirability of a small cabal controlling the affairs of a bank. But as it has been rightly pointed out by Messrs C. P. Lawson and Leslie Gwilt in a dissenting minute, the objective is likely to be defeated by dividing up the holding in excess of 10% so as to ensure the exercise of voting power in proportion with the full holding.

A third form of control over management is Clause 16, a new one, by which no banking company incorporated in India shall have as a director any person who is a director of another banking company. The purpose as in Cl. 11 (c) and (d) and Cl. 12 (3) (d) is to prevent an interlocking of directorates and the concentration of banking power in the hands of small groups. But the wisdom of such exclusion is doubtful, for the provision will have the effect of shutting out from the bank directorate persons having the widest possible range of banking experience and leadership. Similar

prohibitions relating to interlocking of directorates are no doubt to be found in recent American banking legislation. But British banks have always sought directors representing as wide a field of experience, influence and knowledge as possible. The practice, as is amply demonstrated by experience and tradition, has produced excellent results in Great Britain. As the *Eastern Economist* has observed "the proposed ban is based upon the belief that such a prohibition may be enforceable and not evaded, would strictly limit bank directors' interests in other business and banks and is desirable both in itself and as a corrective to the feared concentration of banking power ; but such a belief is unfounded."¹ The case for omitting these provisions is therefore quite clear.

An important issue relating to management has been raised by five signatories to a dissenting minute. They have argued the case for statutory provisions for representation of depositors on the boards of the banks in the same way in which policy holders are given place in the directorates of life insurance companies.² This argument is backed by theory and foreign precedent. In some countries such as Denmark and Norway, boards of representatives, sometimes partly chosen by depositors, as distinct from boards of directors, are to be found, who watch the interests of the depositors. But these boards have merely formal functions. The articles of association of some Indian joint stock banks and of some co-operative banks in Madras have provided for depositors' directors. But the practical difficulties in the way of such representation are almost insuperable and the possible

¹ *The Eastern Economist*, April 25, 1947, p. 746.

² *Minute of Dissent* by Messrs. M. Saksena, S. N. Sinha, M. A. Ayyangar, P. B. Gole and S. S. Sanyal.

repurcussions on banking rule out the proposition from the field of practical politics. Deposits of individuals are fluctuating from time to time and even in the case of fixed deposits elaborate rules have to be made to determine the qualifications of voters. Stipulations have to be made as regards the minimum amount of deposits that will be entitled to voting right, the minimum period of holding, the classification of deposits according to amount etc. Besides, the dual control by the two blocks of directors, one representing the depositors and the other, the shareholders, will entail divided responsibility and will not at all be conducive to a banking policy whose aim is to foster the economic development of the country.

In the background of these new provisions which the Select Committee have proposed, the new Bill as compared with the Bill of 1946 appears to be unduly suspicious of bank management and restrictive of the banker's judgment and discretion.

In conclusion attention should be drawn to the new definition of "banking" which the Select Committee have adopted. It has always been difficult to define a "bank" and nowhere has any definition of banking been evolved which has secured general approval. Banking laws in several countries have indeed avoided a definition of the term "bank" or "banking business". The Bank Act of Canada was content with merely interpreting the term "bank" as any bank to which the Act applied. The recent Australian Bank Act of August 1945 has defined a "bank" as a body corporate authorised under this Act to carry on banking business in Australia. Sec. 277F of the Indian Companies Amendment Act 1936 defined a banking company as a company which carried on, as its principal business, the accept-

ing of deposits of money subject to withdrawal by cheque, draft or order, notwithstanding that it engaged in one or more of a number of permitted forms of business. This definition had given rise to administrative difficulties particularly in determining the "principal business" of a company. Sir James Taylor in his draft Bill of 1939 defined banking as the acceptance of deposits on current account or otherwise, subject to withdrawal by cheque. The emphasis was on "withdrawal by cheque." The subsequent bills defined "banking" as "the accepting of deposits repayable on demand." The Select Committee have considered this last definition as much too brief and unsatisfactory and have proposed to replace it by a more elaborate one which will include the acceptance of time deposits, According to this definition "banking" means "the accepting, for the purpose of lending or investments, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise." A new clause, which will secure the purpose of the definition in the original bill has been inserted. This clause prohibits companies other than banking companies to accept deposits repayable on demand.¹

¹ Clause 8.

CHAPTER III

POST-WAR BANKING CONTROL

The movement for banking reform in the war and recent post-war period has not been confined to India alone. This desire for reform, as usual, has been reflected in an increasing measure of banking control. It is indeed surprising to notice that banking authorities in the United States, a country which is intolerant of controls and puts its faith in free enterprise, are contemplating a measure of control of commercial banking, the like of which is not to be witnessed even in socialist Britain. It is learnt from a recent report of the Board of Governors of the Federal Reserve System that the Board are submitting the following proposals for the consideration of the Congress for the purpose of controlling American commercial banking.¹

1. A maximum statutory limit should be imposed on the amounts of long-term marketable securities both public and private, which a commercial bank may hold against its demand deposits. It would serve to strengthen the bank's demand for short-term securities and limit its demand for long-term government securities.

2. The Board of Governors should be empowered to require all commercial banks to hold a specified percentage of treasury bills and certificates as secondary reserves against their net demand deposits. The banks should be permitted to hold vault cash reserves and excess reserves in lieu of government securities, so that they may meet this requirement.

¹ Thirty-Second Annual Report of the Board of Governors of the Federal Reserve System.

The effect of this measure would be to stabilise interest yields on short-term government securities and, therefore, the cost of public debt.

3. The Board should also be authorised to increase reserve requirements, within some specified limit, against net demand deposits.

The need for these measures has been stressed by the Federal Reserve authorities because they are convinced that in the context of the huge war-time increase in the amount of money supply which is likely to continue for an indefinite time and the prevailing shortage of goods, a mere tinkering with the mechanics of bank control will not affect the basic factors in the situation. This monetary expansion was the direct result of deficit financing from the banking system in war-time. The government has now been reversing its creation of money by redeeming the public debt, it may be recalled, out of its cash balances held with the commercial banks.

There is a persistent tendency in the American banking system towards an unnecessary creation of bank credit as the authorities are always ready to purchase the banks' holdings of one-year certificates at the fixed rate of $\frac{7}{8}\%$. The Board has assured the Treasury that the rate will be maintained if necessary through open market operations. This policy, as the Board points out, makes it possible for commercial banks to sell short-term lower yield government securities to the Reserve system and thus acquire reserves which, on the current basis of reserve requirements, can support a sixfold expansion of member bank credit. That is why the Board is seeking to restrict the commercial banks' investment policy, to keep their longer-term investments within a specified ratio of

their deposits and to compel them to maintain secondary reserves in the form of short-term government securities.¹

These recommendations, however, run counter to American economic philosophy and have already raised a storm of angry protest from the commercial banks. The National City Bank has described them as far reaching extension of controls "substituting in large part for the judgment of individual bankers a complicated system of new rules and regulations dictated by Washington."

The Australian Banking Act, 1945 :

In another country *viz.*, Australia, very wide powers of control over the trading banks have been conferred on the Commonwealth Bank by a new law, the Banking Act of August, 1945. The main objectives of the Act have been stated to be regulation of banking and making provision for the protection of currency and of the public credit of the Commonwealth.

The wide powers of control with which the Act has vested the Commonwealth Bank of Australia will be exercised mainly through the mechanism of "Special Accounts," the regulation of advance policy and the fixation of interest rates payable to or by the banks.

The "Special Accounts" are, a legacy of the National Securities (War-time Banking Control) Regulations which were gazetted on November 26, 1941. These were a sort of compulsory treasury deposit receipts, introduced as part of the policy of overcoming secondary inflation. The banks were directed to deposit with the Commonwealth Bank such part of their surplus investible funds as might be called for in

¹ *The Economist*, August 24, 1946, p. 305.

accordance with a plan approved by the Treasurer. In practice the excess of the banks' assets in Australia over the amount existing in August 1939 was frozen. This arrangement was placed on a permanent basis by the Banking Act of 1945. All banks carrying on business at the time as well as those which will commence business in the future have been required to establish a Special Account with the Commonwealth Bank.¹ Except with the consent of the Commonwealth Bank, no bank shall be entitled to withdraw any amount from the Special Account.² The Commonwealth Bank shall pay interest at half yearly intervals to each bank on its daily balances at a rate not exceeding 17s. 6d. per cent. per annum.³

The provision for these "Special Accounts" has been regarded by many authorities as the most revolutionary feature of the banking legislation. Its effect will be to freeze and render non-investible quite a large proportion of the banks' assets. As a large volume of private lending will be brought to a halt, the government will be free to spend large amounts without intensifying the inflationary forces. *The Statist* has aptly characterised it as an ingenious method of deflecting activity from the private to the public sector of the economy.⁴ But a rigid application of this method will limit the volume of bank advances to the pre-war level in monetary terms in an economy where the wealth value of money has severely declined. From that point of view it will be not quite fair to the private banks. Thus the mechanism of "special accounts" endows the Central Bank with a new

¹ Arts. 18-19. The Banking Act, 1945. (No. 14 of 1945).

² Art. 21.

³ Art. 22.

⁴ *The Statist* (Int. Banking Section) December 7, 1946, p. 13.

means of quantitative control of advances. These accounts amounted on June 30, 1946 to £-A260·1 million.¹

Apart from this quantitative control, qualitative control will be exercised through the control of the advance policy. Art 27 (1) and (2) provides that where the Commonwealth Bank is satisfied that it is necessary or expedient to do so in the public interest, it may determine the policy in relation to advances to be followed by banks. It may also give directions as to the classes or purposes for which advances may or may not be made by banks. This is a step taken beyond the mere control of capital issues to which the public in England and India have grown reconciled as an essential pre-requisite of planned economy.

Here, in Australia, power is being given to authority to prevent banks from making advances, however small, to certain classes of business. Moreover, the drafting has been made in so general and broad a manner that the Commonwealth Bank appears to be empowered to regulate not only the purposes for which advances will be made but also such matters as the security to be taken, the proportion of the advance to the security value and the terms of repayment.² The banks are also not allowed to purchase securities according to their own discretion. They are permitted to subscribe to government and other securities only with the sanction of the Commonwealth Bank (Art. 23.)

The Act has empowered the Commonwealth Bank to make regulations, with the approval of the Treasurer, fixing the rates of interest payable to or by banks and the rates of discount chargeable by banks. The Bank has further been authorised to make regulations providing that interest shall

¹ *Report of the Commonwealth Bank of Australia*, 1946, p. 9.

² *The Statist, International Banking Section*, December 7, 1946, p. 13.

not be payable in respect of (1) any deposit repayable on demand or after the expiration of a period specified in the regulations or (2) that portion of a savings bank deposit account which exceeds a stated amount. The purpose is to discourage the placing of large sums on fixed deposit when they could, with greater national advantage, be invested in government loans. Again, Australia does not possess a highly developed money market like that of England. The Treasury can prepare the way for lowering the rates at which it is able to float its public loans by pushing down the rates of interest paid on fixed deposits by the trading banks. Reductions of $\frac{1}{4}\%$ in maximum rates of interest payable by banks on 12 and 24 months' fixed deposits were announced in November 1945.¹ As regards 24 months' fixed deposits, only the first £10,000 now bears interest at the full rate of $1\frac{1}{2}\%$, any excess carrying 1% only. The Act has considerably enlarged the powers and widened the responsibilities of the Commonwealth Bank. For the protection of the depositors, the Bank may, by notice in writing, require any bank to supply it, within a specified time, with information relating to the financial stability of that bank. Every bank shall also furnish to the Commonwealth Bank such information in respect of its business as the Commonwealth Bank directs.

The banking system in Australia has been operating under the new Bank Act for a brief period. Some of the controls had already existed during the previous four years in the form of temporary regulations introduced under the National Security Act. It will be too early at this stage to expect far reaching changes all at once as a result of the

¹ *Report of the Commonwealth Bank of Australia*, June 30, 1946, p. 15.

introduction of the new legislation. The Australian banking law has some important lessons for India which she may learn with profit. The introduction of a system of compulsory deposit with the Reserve Bank of India to be made by the ordinary banks on the lines of the Australian "special accounts" as an anti-inflationary device may be found to be particularly useful under the inflationary conditions still prevailing. The authorisation of the Reserve Bank to control and fix the rates of interest payable to or by banks as well as the rates of discount chargeable by them may enable the Government of India to pursue their cheap money policy with a greater measure of success than has hitherto attended it. Lastly, a control of advance policy after the Australian pattern may assist in the planned economic development of the country by diverting bank advances along particular channels.

CHAPTER IV

INSURANCE OF BANK DEPOSITS

In discussing recent legislation designed to protect the depositor and regulate the activities of commercial banks, a brief reference has to be made to the American scheme of deposit insurance, the only instance of its kind, adopted in the post-depression period. Originally provided for in the Banking Act of 1933, sweeping changes in the plan were effected by the Banking Act of 1935. A Federal Deposit Insurance Corporation has been created with the Treasury and the Federal Reserve Banks subscribing to its capital.

The banks participating in the insurance scheme have to pay premia at the rate of $\frac{1}{12}$ of 1% per annum upon their total *net* deposits as distinguished from their insured deposits. The Corporation has been further authorised to supplement its resources by issuing bonds, notes or other obligations in an amount equal to three times the payments received on account of capital stock and the 1936 assessments upon insured banks. The coverage provided for under the Act is not a cent per cent but only a partial coverage. The maximum amount of insurance for any depositor is \$5,000 in any one insured bank. The F.D.I.C. has been given very wide powers to examine and direct insured banks. If abuses are disclosed and not corrected within a reasonable time, the Corporation may publish the pertinent sections of the examination report. Unsound banks may be expelled from the fund or their liquidation may be ordered. Insurance may further be refused to banks which do not serve the "convenience and the needs of the community." The Corporation may facilitate a merger or con-

solidation of an insured bank with another insured bank by making a loan to the purchasing bank. But such a merger can take place if it is satisfactory to the Corporation, so that it may not be burdened with the doubtful assets of an unsound bank.¹ According to the reports of the Corporation, such powers have been extensively used.

The plan of insurance of bank deposits is a combination of two ideas which were "born of the holocaust of bank failures and the bank holiday" of 1933. There was an insistent popular demand for some kind of deposit insurance owing to the widespread distress caused by numerous bank failures in the crisis. Millions of dollars of deposits frozen and immobilised owing to these bank failures would, it was apprehended, produce serious deflationary effects. The rôle of deposit insurance is thus two-fold ; first, the prevention of deposit withdrawals by recreating confidence and thereby freeing the banks from a strong pressure to liquidate; and secondly, to maintain the volume of circulating media in the event of bank failures. In relation to business cycles, it is clear, insurance of bank deposits will act as an anti-deflationary device.

The question of introducing deposit insurance in India may be considered in this connection. India is a country whose record in bank failures is almost as bad as that of the U.S.A's. Our depositors' fingers had been burnt so frequently and so badly that any plan which aims at covering their risks at least to some extent deserves commendation. Insurance of bank deposits has a special significance in the post-war period. As a result of the war, there has been a considerable

¹ "The Banking Act of 1933"—Art. by R. B. Westerfield, *Journal of Political Economy*, December 1933, also 'The Banking Act of 1935' Art. by H. H. Preston, in the *Journal of Political Economy*, December 1935.

accession of money to the lower income groups who have placed their savings in the numerous banks which have recently sprung up. These bank depositors are generally ignorant and can neither distinguish between sound and unsound banks nor keep a watch over the practices of their own banks. Apart from general banking legislation, the safety of the depositors would be considerably increased by adopting a scheme of insurance more or less on the lines of the American plan. The creation of a Deposit Insurance Corporation under the auspices of the Central Government would also give a powerful impetus to the development of joint-stock banking in India by making it plain to the public that the entire credit and weight of the Government were behind the banks.¹

But in recommending insurance of bank deposits for our country, the most important question to be decided first is the question of the coverage to be provided. Would it be a restricted or a hundred per cent coverage? It has been contended that the usefulness of deposit insurance in preserving confidence and maintaining the volume of circulating media has been considerably limited by the restricted coverage provided under the American scheme. Indeed it could be made much more useful socially if the limited coverage was replaced by a cent per cent one. But the cost factor is very important.¹ If a partial coverage scheme protects by far the most numerous proportion of the depositors, while a cent per cent coverage entails a cost much too great relatively to the few extra depositors to be benefited, the former is certainly to be advocated. If, for instance, a plan of insurance guaranteeing Rs. 5,000 of deposits is found to protect more than 95% of the deposit accounts in the Indian banks, it will

¹ Brij Narain, *A Detailed Plan for the Development of Indian Joint-stock Banking*, p. 85.

not be prudent to saddle the Corporation with an enormous liability by adopting a cent per cent coverage for the benefit of the holders of less than 5% of the accounts, who are admittedly large depositors and as such are able to take care of themselves.* This class of depositors, again, are frequently borrowers from the banks so that in the event of bank failures they can always offset their deposits against their indebtedness.

There are other questions, namely, those of whether the loss to depositors through bank failures is a risk which can be insured against on a sound actuarial basis and how the cost should be allocated. As Mr. H. Jones has pointed out, neither the risk is strictly an insurable one nor the allocation of cost according to benefit is practicable. "The major factor militating against the insurability of the risk is the catastrophe hazard involved."¹ But it does not follow that deposit insurance is not socially desirable. It simply means that in creating a Deposit Insurance Corporation it must be frankly recognised that no truly insurable risk is involved. The Corporation must be equipped with an adequate income and may even have to look up to the government for assistance in order to avoid the disaster that had overwhelmed a number of state insurance schemes adopted in the U. S. A. prior to the inauguration of the Federal scheme.) As Mr. Goodbar has observed, the Corporation simply can not be permitted to fail.² If losses occur, not only should the Government come forward with its assistance but the insured banks must be asked to foot the bill in the form of increased assessments.

* An enquiry into the size of deposit accounts in the insured banks has to be conducted.

¹ Art. by H. Jones entitled "Insurance of Bank Deposits in the U. S. A." in the *Economic Journal*, December 1938.

² J. E. Goodbar, *Managing People's Money*, pp. 406-11.

If such a Corporation is established in India, one of its first tasks would be to announce a programme for weeding out all weak banks in the country. This would follow two directions. First, weak banks should be located and amalgamated with stronger ones. Secondly, a careful study of all insured banks should be undertaken with a view to the further elimination of all banks having no sound economic reason for existence. If the programme is properly carried out, the Corporation will be able to render very handsome services. The tension in over-banked areas would be relieved, the rate of bank mortality would be reduced and banking practices would be improved. But it should be remembered, as the American Federal Deposit Insurance Corporation itself admitted, that deposit insurance is not a "wonder drug", curing all ills of the banking system as well as the unstable business conditions which in the past culminated in banking crises.¹

¹ *Annual Report of the F. D. I. C.* 1934, pp. 36-37.

CHAPTER V.

NATIONALISATION OF COMMERCIAL BANKS.

A work dealing with recent banking developments would not be considered complete without a reference to a subject which has become an important political issue in some countries, namely, nationalisation of commercial banks. This question, as that of the socialisation of central banks studied in a previous chapter, has come to attract a great deal of attention in recent years. In some quarters control of joint-stock banking by mere legislation is not considered sufficient and the entire commercial banking system is accordingly sought to be brought under public ownership and control. In the context of the post-war policies of full employment and economic planning, the question of public control of commercial banks as providers of short-term finance has been endowed with added significance.

The main arguments adduced in favour of nationalising the commercial banks may be summarised under the following heads: (1) The banks create money which is the prerogative of the state and hence should be strictly controlled by the latter. (2) Independent commercial banks are not amenable to control by central banks. (3) Such banks may thwart the progress of nationalised industries and sabotage a socialist government. (4) Nationalised commercial banks, on the other hand, would distribute credit much more efficiently than banks under private ownership and control and the cost of credit would be lowered.¹

The issues raised above have been aptly characterised by Mr. Sayers as *the Monetization Issue, the Integration Issue*,

¹ See A. B. White, *The Nationalisation of Banking*, pp. 43-59.

*the Socialization Issue and the Efficiency Issue.*¹ Between them, they practically exhaust the arguments of the protagonists of nationalisation.

Proposals for socialization have, on the other hand, been opposed on the following chief grounds. In the first place, the privacy of bank accounts will be impaired and the state officials, particularly the police and the income-tax department, will be furnished with a new weapon to harass the public. In the second place, it is feared that discrimination would be practised under state banking in the matter of granting and refusing loans and the whole business may become a political question. In the third place, it is contended that state banking would be dangerous for the depositors.²

Neither the arguments for nor those advanced against nationalisation of banking are irrefutable. Replies may be, and indeed have been, given to each one of them. In actual practice, in England, while the central bank has been nationalised, the joint-stock banks have been left in private ownership but Clause (4) of the Bank of England Act has given wide powers of control over the ordinary banks. The French Government, however, rejected control of deposit banks on the model of the British Clause (4) and proceeded to nationalise not only the central bank but also four deposit banks. These deposit banks are the Credit Lyonnaise, Societe General, Comptoir National-d' Escompte de Paris and the Banque Nationale pour le Commerce et l' Industrie. Their shareholders were not to be bought out at once but over a long period (50 years) at prices to be determined by the valuation board by reference to market values. Meanwhile the shareholders would be retaining their shares and the

¹ R. Sayers, *Modern Banking*, pp. 304-5.

² See G. D. H. Cole, *Money, Its Present and Future*, pp. 199-203.

dividend to be guaranteed by the Government would not be less than that of 1944. According to Art. 8 Law No. 45-015 of December 2, 1945, the shares of the nationalised institutions shall be transferred to the State as of January 1, 1946. The banks shall deliver to the shareholders, in exchange for their shares, registered dividend bearing scrip which beginning with the year 1946 shall be entitled to a dividend fixed each year by the Board of Directors not less than the dividend distributed on the shares for the year 1944. Beginning January 1, 1947, the State shall repurchase each year at least 1/50 of the dividend bearing scrip outstanding at that date. The repurchase price shall be equal to the average quoted price of the share on the Paris Stock Exchange during the period from September 1, 1944 to October 31, 1945.¹

The shareholders would be deprived of all control of their undertakings. The boards of directors in each case would be made up of 12 government appointees, (1) four representing industry, commerce and agriculture; (2) four, the trade unions; (3) two, the Bank of France or the public or semi-public credit institutions; and (4) two others with banking experience.² The plan was not a comprehensive one, as all the other deposit banks were left outside the scheme. The Government considered it desirable to retain a private competitive sector with a view to prevent the nationalised banks from growing much too bureaucratic. But it is difficult to see how it did not involve a negation of the main policy of the Government. Perhaps there was some justification for drawing the line and stopping short of the four banks. Together they held nearly 55% of the total deposits and "were in the nature of public services," as they had a truly national

¹ *Federal Reserve Bulletin*, May 1946, pp. 484-85.

² *The Economist*, December 8, 1945, p. 835-36.

network.¹ Two out of the "Big Six" deposit banks were omitted from the nationalisation scheme but omission might be only temporary, and all the six banks, as the *Economist* observed, were thus likely to lose their independence soon.³

As a result of the process of nationalisation, however, the general policy of the four French banks does not appear to have been substantially modified. By far the greater proportion of their resources had already been invested in short term treasury bonds and there was hardly any scope for any considerable change in that direction. Their business practices are still mainly on the traditional lines. There is an interesting break with the past in one respect—the growing practice of rediscount of commercial bills by the big banks. The shareholders have been said to be the principal victims of this nationalisation. The terms of compensation provided by the law of December 2, 1945, proved to be so unjust and impracticable in some respects that they had to be altered by subsequent legislation.³

Now Zealand presents an interesting and unique experiment, that of extending direct control over the banking system, not through the Central Bank but through the agency of a nationalised commercial bank in active competition with other banks. By the Bank of New Zealand Act passed at the end of 1945, provision was made for transfer of shares from private shareholders of the Bank of New Zealand, the country's largest trading bank, to the Government. A board of directors, not less than five and not more than seven

¹ *The Economist*, December 8, 1945, p. 836.

² The Government's Bill to nationalise the Bank of France and the Big Four Deposit Banks was adopted on December 2, 1945 by the French Assembly by 521 votes to 35. *The Statesman*, December 3, 1945.

³ *The Statist. Int. Banking Section*, December 7, 1946 ("Banking Nationalisation in France"), pp. 10-11.

persons, were to be appointed by the Minister of Finance. The Board would be under obligation "to give effect to any decision of the government conveyed to them in writing by the Minister of Finance".¹ But the weapon of direct control over the policy of a trading bank may be fraught with disastrous consequences.

There is one strong ground on which it would be difficult to accept a comprehensive plan of nationalisation of the ordinary banks. That would sound the death-knell of an independent race of bankers whose advice and service are worth having. If, however, a general policy of socialization is favoured and the banks have to be nationalised, it should be done only after socialization of the major industries and trades has taken place. The question then would be not one of choosing between private and nationalised banks but that of the *timing* of bank nationalisation.² Even in that case the amalgamation of all the existing joint-stock banks into one Grand Bank of Great Britain or of the Union of India, allowing depositors no choice, and bankers no scope for emulation, would not be desirable. It is interesting to notice that ambitious plans for the complete merger of the four French nationalised banks, which were reported to be under way when the nationalisation law was passed, have since been abandoned. The policy of socialization of banking does not necessarily involve the merging together of all the units brought under public ownership. The individual banks may continue to operate as parts of a socialised whole, clustering round a socialised central bank, just a piece in the whole mosaic.

¹ *The Statist. Int. Banking Section*, December 7, 1946 ("Development in New Zealand Banking"), p. 15.

² R. Sayers, *Modern Banking*, p. 309.

PART FOUR

**POST-WAR MACHINERY FOR INTERNATIONAL
MONETARY CO-OPERATION⁴**

CHAPTER I

CENTRAL BANKS *VIS-A-VIS* THE INTERNATIONAL MONETARY FUND.

The Articles of Agreement of the International Monetary Fund entered into force on December 27, 1945, when a ceremony of signatures was held in Washington in which representatives of thirty countries participated. The First Annual Meeting of the Board of Governors opened on September 27, 1946. The Fund finally opened its doors for business on March 1, 1947. The working of the Fund's organisation will be watched with interest by all member countries. In the meantime it will be worth while to make a detailed analysis of the position of the national Central Banks *vis a vis* the Fund. One of the most important lessons furnished by the monetary disorder of the inter-war period is that international monetary problems should be solved by mutual agreement. The members of an international monetary system are for good or evil in the same boat. The action of each member affects every other member. If certain accepted rules are not followed by the team, if each member of the crew acts in his own way, the craft will be rocking dangerously and may even founder, when all will perish. The intransigence of each member would harm him as much as the others. Similarly national policies have their international repercussions. If the members of an international system are unwilling to observe accepted rules of international behaviour, the entire system will break down much to the detriment of them all. Thus an international monetary system must be based upon international co-operation. An

attempt at co-operation was made by the signatories of the Tripartite Agreement of September 25, 1936. But international monetary co-operation to achieve its objective would have to be multilateral and much broader in scope. The most suitable vehicle through which such co-operation may be rendered would be a permanent institution, providing "the machinery for consultation and collaboration on international monetary problems."

This permanent institution would partake of the character of a central institution wherein international monetary functions would be concentrated. The creation of such a central banking institution was proposed in the recent plans for an international clearing system associated with the names of Lord Keynes and Mr. White. The same idea runs through the compromise formula to be found in the Joint Statement by Experts which was finally embodied in the Bretton Woods Agreement with slight changes. The Experts believed that the most practical method of assuring international monetary co-operation would be through the establishment of some such machinery as that evolved at Bretton Woods. The proposed institutions whether called an "International Clearing Union" or "a United and Associated Nations Stabilization Fund" or "an International Monetary Fund" may be regarded, as Mr. Halm has aptly observed, as different blue prints of an "International Reserve Bank," bearing a close analogy to the Central Reserve Banks of the different national credit systems.¹

A great deal of misapprehension appears to exist in many quarters as regards the relation of the gold and foreign exchange reserves of national central banks to the Fund's

¹ George N. Halm, *International Monetary Co-operation*, p. 51.

reserve of international currency. A question which has worried many people is whether there would be any need for the central banks to maintain reserves of their own when the resources of the Fund would be available. That view of the Fund which envisages it as an enormous organisation making its facilities habitually available to national central banks in ordinary normal circumstances and clearing every transaction in the world through its offices is highly misleading. The relationship between the Fund and national central banks is well expressed by the classical conception of central banking as "lender of last resort." The orthodox English conception of central banking differs in this respect from the conception of central banking as understood in the United States. According to the former, the central bank should function as the ultimate source of credit to be resorted to only when the ordinary channels fail to furnish it and the circumstances are quite abnormal. The central bank in such cases is quite prepared to help the member banks but on its own terms. It will charge interest for such accommodation at a rate which will deter them from approaching the Bank in ordinary times. It is only in abnormal times that they will be willing to pay this penalty rate to tide over the temporary difficult situation. According to American conception, the Federal Reserve Banks have not been designed to function as emergency institutions. As Lord Keynes wrote, the Federal Reserve system is regarded as a costly and permanent organisation which should continuously occupy itself in the interest of industry and commerce and whose rediscounting facilities should be habitually available to the member banks, even in ordinary circumstances to meet their day to day needs.¹ True to the English conception of central

¹ J. M. Keynes, *A Treatise on Money*, Vol. II, pp. 226-228.

banking, the Fund will have nothing to do with the every day business of the national central banks. It is intended to assist them by providing a line of credit only to meet a temporarily unbalanced situation. In order that a member country may be deterred from using the resources of the Fund in excess of what is required to meet a short period disequilibrium, the rates of interest charged on the accommodation granted—the “service charges” as they have been called,—have been scheduled to increase with the increase in the amount and duration of the member country’s borrowing. The establishment of the Fund does not certainly mean that it would no longer be necessary for national central banks to maintain their own reserves of gold and foreign exchange. The size of these reserves of international currency will be different for different central banks and will depend, as we have already seen, upon a variety of factors. The resources of the Fund will not be available to the central banks in the usual case. It is only when the circumstances are abnormal and the member country has incurred a temporary deficit in its international balance of payments that the ordinary international currency reserve of the country’s Central Bank will be supplemented by the resources of the Fund. Thus the Fund’s resources of international currency will operate as “a second line of defence”, as Mr. Hansen has well observed, upon which the country in question may fall back in the event of a temporary disequilibrium in the balance of payments.¹ The central bank’s own resources may be said to constitute the perimeter defences. It is only when the perimeter defences collapse under the force of the assault that these inner defences may be utilized. Indeed an important

¹ A Hansen, *America’s Role in the World Economy*, p. 55.

objective of the Fund is "to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members."¹ The line of credit guaranteed by the Fund will provide an opportunity to member countries to correct maladjustments "without resorting to measures destructive of national or international prosperity",² such as deflation, currency depreciation, tariffs and exchange control, so familiar in the inter-war period. While a country is fighting hard to overcome temporary difficulties, the provision of a limited amount of short-term credit through the Fund will be in the nature of a safety and precautionary measure. The country in question will be reassured and will refrain from adopting undue restrictions of the above type which would seriously reduce the volume of world trade and react on all countries unfavourably. It would also act as an insurance against the complete breakdown of international monetary arrangements. It can not be stressed too strongly that by far the greater proportion of international payments would be cleared in the ordinary way through the foreign exchange market without calling into aid the machinery of the Fund. Thus the International Monetary Fund, as proposed in the Bretton Woods Conference in July 1944, and as formally set up on December 27, 1945, has been designed to function as a bank of central banks, a sort of "capstone" in the structure of the world's monetary system.³ The same considerations which had in the past stimulated the development of central banks reached their logical conclusion in the establishment of this International Central Reserve Bank.

The position of national central banks *vis-a-vis* the Fund

¹ Art. I (vi).

² Art. I (v).

³ G. N. Halm, *Monetary Theory*, p. 264.

may be analysed in the following manner. Lord Keynes in his own inimitable way had described the national central banking system as the Sun with the member banks grouped round it as planets. The Fund may similarly be regarded as the Sun round which the central banks of the various member countries cluster. The member banks in the national banking systems function as repositories of cash balances of individuals and business firms ; and the central banks act as repositories of the reserve balances of the member banks themselves. Now that the Fund will operate, the liquid resources of the national central banks will be pooled together in the Fund in the same manner in which the cash resources of the member banks are pooled together in the central banks themselves. Just as the integration of the credit policies of the various commercial banks is an important part of the central bank's task, so will the harmonization of the monetary and general economic policies of the member countries constitute an important part of the Fund's operations. The liquidity of the commercial banking system depends not only on the mobilisation of its scattered resources in a common reservoir, the central bank, but also in the availability of a larger supply of reserve funds, if necessary, to meet a widespread demand for currency in an emergency situation. The I. M. F. like a truly International Reserve Bank has not only created a mutual exchange pool of international currency but will also make available, if not actually "create," more international currency. Like the Keynesian Clearing Union the I. M. F. has not been endowed with the power to create international money. The Fund's resources of international money are derived from two sources, capital subscriptions and borrowings. But the Fund may be said to create such money in a special sense. First, each member country has to

contribute a certain portion of its quota in its own currency. When these resources of national currencies will be paid into the international exchange pool, they will assume a new character, that of "foreign" currency. Secondly, no body will imagine that the contributions in terms of national currencies will be made by withdrawing a corresponding amount from the domestic circulation. That would be causing an unwarranted deflation. They will probably be created for this very purpose by the national central banks. A greater assortment of available local currencies in the common pool of the Fund will be likely to become a source of strength to the central banks. The central banks of member countries have not certainly abdicated their monetary sovereignty to the Fund. They have not empowered it to create their own national currencies. Thus it is clear that although the I. M. F. is a banker for central banks in the same way as a central bank is a banker for the ordinary banks, yet the analogy must not be carried too far. It must also be observed in this connection that the member countries would not like to divest themselves of sovereignty in respect of their domestic economic policies. Further, unlike the national central banks which pool reserves of one kind of money, the Fund will pool the reserves of a number of different countries.¹

Strictly speaking, the Fund does not lend but "sells rights" to foreign currencies. In order to be entitled to a "buying right,"—to a line of credit, as we would ordinarily say, the member country has to make an initial contribution to the Fund partly in "gold" and partly in its own "currency".) Each member has been assigned a quota and its subscription is equal to this quota. Each member will pay 25% of its

¹ George Halm, *Monetary Theory*, p. 265.

quota in gold or 10% of its gold holdings whichever is smaller and the balance of the quota in its own "currency". The Joint Statement of the Experts had used the expression "local funds" and was not explicit as to whether it meant currency or securities or a combination of the two, as in the American plan.¹ In the Articles of the I. M. F. the expression "currency" refers to domestic currency in the form of a deposit account entered in its own central bank to the credit of the Fund or it may even be non-negotiable non-interest bearing obligations of the member government, payable at their par value on demand, deposited with the central bank to the credit of the Fund. The full line of credit to which a member country is entitled—its "buying right"—is equal to the quota assigned to it made up of gold and currency. Gold depositories have been established in New York, London, Paris, Bombay, Shanghai *i.e.*, in the territories of the Big Five of the Fund. The gold in the Fund will be held with the depositories specified by the members.

This quota fulfils a series of important functions. It determines the amount of a country's contribution of resources to the Fund. It defines the normal degree of access by a country to the foreign exchange pool of the Fund. It indicates a general measure of the economic significance of a country and of its relative voice in the management of the Fund. But it is strange that the Bretton Woods Agreement has nowhere given a hint as to the criteria by which the quotas were determined. In the Keynes plan, the primary criterion for determining the quota was the value of foreign trade which was considered to be most relevant to a plan chiefly concerned with the regulation of foreign exchange and of a country's trade balance. In the White

¹ Art. by E. V. Morgan in the *Economica*, August, 1944, p. 113.

plan, it was a multiple basis of the country's holdings of gold and free foreign exchange, national income and the magnitude and the fluctuations in the international balance of payments. The Joint Statement issued by the Experts, however, omitted any reference to any such formula for determining the quota. The reason for the omission was said to be the desire to avoid a decision of such a matter before there was an opportunity to consult prospective participants. But it was recognised at the Bretton Woods Conference that any satisfactory basis for the determination of the quota must necessarily be complex and must relate to the multiple functions of the quota noticed above. Hence factors like the following have to be regarded as relevant to the determination of the quotas: (a) national income, which is a good index of a country's ability to contribute its resources to the Fund; (b) a country's gold and dollar holdings which are the equivalent of international purchasing power and therefore particularly desirable assets for the purpose of an international monetary institution; and (c) lastly the magnitude of fluctuations in a country's balance of payments which is an excellent barometer for a country's foreign exchange needs. Besides these there is the intangible factor, "the economic significance of a country in the world economy." It depends upon the country's foreign trade and investment, economic and political strength and its material output. In the final calculation of the quotas, allowance should be made for this intangible factor and the necessary adjustment should be made. Taking into consideration all these factors, a formula was applied but the precise determination of the final result is not directly traceable to the terms of a definite formula. This is so because of the large adjustments which have been made in consequence of the intangible factor of economic

significance referred to above. As Mr. Harry White explained to the Indian Delegates to the Bretton Woods Conference after the announcement by Mr. Henry Morgenthau of India's quota of 400 million dollars, they had, to start with, applied an economic formula but had made necessary adjustments in the determination of the final quota to allow for the economic and political significance of a country which could not be quantitatively represented by the exact terms of a formula.¹

Although as noticed above, the line of credit to which a member country is entitled is equal to its quota of currency and gold, yet there is a definite limitation upon the extent of its use of the facilities of the Fund. No member country is entitled to draw an amount exceeding 25% of its quota in any year. According to Art. V. Sec. 3 (iii) a member is entitled to buy another member's currency from the Fund in exchange for its own currency provided the purchase would not cause the Fund's holdings of the purchasing member's currency to increase by more than 25% of its quota during the previous 12 months nor to exceed 200% of its quota. But the 25% limitation shall apply only to the extent that the Fund's holdings of the member's currency have been brought above 75% of its quota if they had been below that amount. These restrictions upon the extent and range of the draft by a member on the resources of the Fund were objected to by some countries on the ground that certain countries required greater elasticity and latitude in the use of their quota owing to extreme seasonal disturbances, large price variations and severity of the incidence of the business cycle, all of which

¹ Report of the Indian Delegation to the United Nations Monetary and Financial Conference at Bretton Woods, July 1944, pp. 17-18.

were calculated to produce a wider amplitude of fluctuations in their balances of payments.¹ But these restrictions were considered to be desirable and necessary. It would be to the collective interest of the deficit countries themselves that the Fund should pursue a policy of carefully husbanding its resources and building up its prestige and credit. Again, if the Fund were much too liberal in allowing the use of its facilities, the resources of vital and important currencies at the disposal of the Fund would be quickly exhausted in meeting the demand for those debtor countries which fortunately happen to be at the head of a long queue, much to the chagrin of those who have been late in pressing their claims. These restrictions have indeed a double significance. Not only do they provide a safeguard against a speedy exhaustion of the Fund's holding of scarce currencies but they would also compel members to adopt the necessary corrective measures to restore equilibrium at an early date.

The Fund does not intend to convert what it has lent for a short period into a long-term loan. The member country is not expected to exhaust its whole line of credit or remain in large or persistent indebtedness to the Fund. Art. V Sec. 8 has laid down certain interesting provisions whereby member countries, who are net buyers from the Fund's foreign exchange pool, may be induced to adopt means by which the Fund's holdings of their currencies may be reduced. As the Fund is designed to provide short-term credit only, it is appropriate that member countries which abuse the privileges should be made to pay heavy penalty charges. Apart from the uniform service charges of three-fourths per cent

¹ Report of the Indian Delegation to the Bretton Woods Conference, p. 25.

in addition to the parity price which every member country has to pay when it buys another member's currency from the Fund, it has been provided that "the Fund shall levy charges uniform for all members which shall be payable by any member on the average daily balance of its currencies held by the Fund in excess of its quota."¹ The schedule of charges analogous to interest is in an ascending scale, rising in two dimensions. The rate increases as the duration and amount of the excess increase. In other words, the larger the amount of the loan and the longer the period over which the loan runs,—the higher the rate. Thus combining the two criteria of "amount" and duration "a sensitive index is created for the tardiness of a member in its equilibrating efforts."² Indeed the Fund is prepared to waive aside the conditions which have been laid down to govern the use of its resources so that member countries may be encouraged to avoid their large or continuous use. In making a waiver, the Fund shall take into consideration periodic or exceptional requirements of the member requesting the waiver.

The Fund conducts its lending business on prudent and sound lines not only in that it charges interest for its loans but also in that it calls for adequate security against every loan. The contribution of the quota in "currency" and gold has no doubt entitled a member country to draw upon its line of credit, but it will not be allowed to exercise its buying right unless it puts in additional collateral over and above the amount already deposited. To the extent that a member country desires to borrow another member's currency, it must place additional local "currency" in its central bank to

¹ Art. V, Sec. 8 (c).

² G. N. Halm, *International Monetary Co-operation*, p. 68.

the credit of the Fund. If India wants to borrow American dollars equal to one-fourth of her quota, she will have to place an equivalent amount in "currency" (*i.e.* in rupees or non-interest bearing Government of India securities) in the Fund's account with the Reserve Bank of India. The Fund's rupee account with the Reserve Bank of India will go up and its dollar account with the Federal Reserve Bank of New York will go down. The collateral in this case will be five times the amount borrowed and the ratio of the security provided by India for the amount she has borrowed will stand at 5 : 1. Deficit countries are thus paying not only full value in their own currency for the facilities granted by the Fund but also, as we have seen, interest charges as if they were borrowing. These charges go into the general income of the Fund. Under Art XII Sec. 6 (b) if any distribution of the Fund's net income is made, there shall first be distributed a 2% non-cumulative payment to each member on the amount by which 75% of its quota exceeded the Fund's average holdings of its currency during that year. The balance is to be paid to all members in proportion to their quotas. This is an advantage which surplus countries will, under the scheme, enjoy over the deficit countries. Again, on some crucial issues voting power will be taken away from deficit countries to surplus countries [Art XII Sec. 5 (b)]. All these provisions have the effect of giving a pro-creditor and anti-debtor bias to the Fund which was absent in the original plans. It is perhaps desirable to penalise countries with a chronic excess of imports over exports. But it is debatable how far it is right to reward countries with a persistent favourable balance of payments.¹

¹ *The Economist*, August 12, 1944.

The provisions in Art. 5 Sec. 7 relating to the repurchase by a member of its currencies held by the Fund are highly significant in this respect and have to be carefully studied. They are intended to limit the use of the Fund's resources by a member when it has other sufficient means of international payment. The member will also have to share with the Fund any increase in its monetary resources which may take place from time to time.

A member may repurchase from the Fund and the Fund shall sell for gold any part of the Fund's holdings of its currency in excess of its quota. At the end of each financial year of the Fund, a member shall repurchase from the Fund with gold or convertible currencies part of the Fund's holdings of its currency under the conditions given below :

(1) Each member shall use in repurchases of its own currency from the Fund an amount of its monetary reserves equal in value to one-half of any increase that has occurred during the year in the Fund's holdings of its currency plus one-half of any increase or minus one-half of any decrease that has occurred during the year in the member's monetary reserves.

(2) If after the repurchase described above has been made, a member's holdings of another member's currency (*or of gold acquired from that member*) are found to have increased by reason of transactions in terms of that currency with other members or persons in their territories, the member whose holdings of such currency (or gold) have thus increased shall use the increase to repurchase its own currency from the Fund.

. But none of those adjustments shall be carried to a point

at which the member's monetary reserves are below its quota or the Fund's holdings of its currency are below 75% of its quota or the Fund's holdings of any currency required to be used are above 75% of the quota of the member concerned.

In determining the extent to which repurchase of a member's currency from the Fund shall be made with each type of monetary reserve, *i.e.* with gold and with each convertible currency, the following rule applies:¹

(1) If the member's monetary reserves have not increased during the year, the amount payable to the Fund shall be distributed among all types of reserves in proportion to the member's holdings thereof at the end of the year.

(2) If the member's monetary reserves have increased during the year, a part of the amount payable to the Fund, equal to one-half of the increase shall be distributed among those types of reserves which have increased in proportion to the amount by which each of them has increased. The remainder of the sum payable to the Fund shall be distributed among all types of reserves in proportion to the member's remaining holdings thereof.

(3) If after all the repurchases required under the Article had been made, the result would exceed any of the limits referred to above, the Fund shall require such repurchases to be made by the members proportionately in such manner that the limits will not be exceeded.

The broad objective of these provisions is to bring about a constant replacement of the Fund's resources by gold and prevent the piling up of "dead stock". It is essential that the

¹ Schedule B. Provisions with respect to Repurchase by a Member of its Currency held by the Fund.

Fund should not be stocked with unsaleable currencies, in other words, currencies for which there is no demand at the present moment. At the same time, it is essential that the Fund's stock of vital and important currencies—currencies for which the demand is much greater than the supply *i.e.*, scarce currencies as they have been called—should not be dissipated. The Fund's liquid position will be impaired and indeed it will be crippled altogether, if it were to lose continuously the latter in exchange for the former. Its liquid position can be improved by increasing the shiftability of its resources. Now gold is an asset which can always be converted into any currency which the Fund may need, since the Fund may require all members to sell their currencies to it for gold.¹ In the absence of these provisions members could not have been prevented from utilising the Fund's resources whenever they needed foreign exchange and building up at the same time resources of gold and foreign exchange yielded by a favourable balance of payments. How the resources of the Fund will not be allowed to be diverted to the creation of idle balances may be illustrated by referring to India's case. The repurchase provisions are of particular significance for countries like India which conduct their foreign trade in terms of foreign currencies and which maintain their balances in these currencies.

Suppose India has a surplus balance of payments with the United States and an overall favourable balance of payments. She will be allowed under the general mechanism of the Fund to accumulate dollar balances. Such accumulation would not involve a drain on the dollar resources of the Fund or of

¹ Art. VII, Sec. 2 (ii).

other countries. Again, if India acquires dollars not from the United States, but from Brazil, a third country, in the course of trade with it, she can utilise these dollars to make payments in the United States or in third countries. In either case there is no strain on the dollar resources of the Fund. But if India acquires the dollars from a country other than the United States, say Brazil as before, and *builds up dollar balances*, her favourable balance of payments would have drawn dollars from the Fund or from other countries. Thus the initial contribution made by the United States to the Fund, *i.e.*, the Fund's dollar account, will be drawn upon to finance the deficit of Brazil in her trade with a third country, India, and help the latter to pile up idle dollar balances. The repurchase provisions were intended to avert this result by ensuring that the Fund's holdings of a country's currency are used to meet its favourable balance of payments or the final liabilities of other countries to it.¹

(An important consideration in this connection is the question of the criteria to be applied by the Fund in order to determine whether its resources, purchased by the central bank of a member country, have been properly employed.) A closely allied question is the disciplinary action which the Fund should take against a delinquent member. The provisions laid down in Art V Secs. 3 and 5 are reminiscent of the measures adopted by national central banks to ensure qualitative control of credit. The American Banking Act of 1933, for instance, required every Federal Reserve Bank to keep itself informed of the loans and investments of its member banks with a view to ascertain whether "undue use" was

¹ Report of the Indian Delegation to the Bretton Woods Conference, pp. 25-26.

being made of Federal Reserve credit. Whenever a bank was considered to be guilty of such improper use of central bank credit, the Federal Reserve Board, as it was then called, might in its discretion, after giving reasonable notice and an opportunity for hearing, suspend the delinquent bank from further use of such credit. A number of conditions have been laid down governing the use of the Fund's resources. The member desiring to purchase a particular currency has to represent that it is presently needed for making, in that currency, payments which are consistent with the provisions of the Agreement. Secondly, the Fund must not have given notice that its holdings of the desired currency have grown "scarce"; in other words, the currency in question has not been rationed. Lastly, the Fund has not previously declared that the member desiring to purchase is ineligible to use the resources of the Fund, because it has made an unauthorised change in the par value of its currency or has employed the Fund's resources for capital transfers, or has failed to fulfil any of the provisions under the Agreement. Whenever in the judgment of the Fund, a member will appear to employ the resources of the Fund in a manner inconsistent with its purposes, a report will be presented to the member setting forth the views of the Fund and prescribing a suitable time limit for a reply. The Fund may suspend the member in question from further use of its facilities simultaneously with the presentation of the report. If no reply is received within the prescribed time or if the reply received is not satisfactory, the Fund may restrict the use of its resources by the member or may even declare the member to be ineligible for the use of such resources. But it is scarcely necessary to point out that it will be very difficult to prove that the member is making an "undue" or improper use of the Fund's resources.

In the First Report of the Executive Directors of the Fund (September 1946) the Directors have clearly set forth the considerations that will determine their policy in making available the resources of the Fund. While emphasising that the Fund's resources should not be used for a large and sustained outflow of capital or for relief and reconstruction, the directors believe that members are not necessarily debarred from the use of the Fund's facilities because they are importing "relief type" goods or because they are importing machinery and equipment for replacement purposes. The Fund will make no attempt to examine the specific use to which each parcel of foreign exchange purchased by a member from it may be put. Such an attempt would indeed be futile for a member will be using its own exchange resources at the same time and it can certainly choose to assign any particular expenditure of foreign exchange to any of these sources. "What is significant is the magnitude of the use which a member makes of the Fund's resources and the prospective balance of payments position of the member."¹

The avoidance of the use of the Fund's facilities for reconstruction and relief should be considered from this view point. The Fund can not exhaust its foreign exchange resources by serving as a relief agency like the UNRRA. It should not sell foreign exchange to a member where there is hardly any likelihood of its repaying the Fund. It must not allow members to use resources of the Fund for financing long-term reconstruction plans which would involve a sustained use of the Fund's facilities for meeting a persistent deficit in the balance of international payments.) "The essential test," runs

¹ First Report of the Executive Directors of the Fund, September 1946. *Federal Reserve Bulletin*, October 1946.

the Report, "of the propriety of the use of the Fund's resources is not the character of the goods imported, but rather whether the prospective balance of payments position of the country concerned (including long-term capital movements) will be such that its use of the Fund's resources will be of relatively short duration."¹

The application of these criteria is likely to be a source of disappointment and resentment among unsatisfied borrowers in the beginning. It is also recognised that there will be errors of judgment in assuming risks of one kind or another. But that, it has been urged, will not deter the Executive from pursuing their objectives and even take risks which would not be justified under normal circumstances.

Let us now analyse the effects which transactions with the Fund will produce upon the money, credit and price structure of the member countries. An automatic equilibrating process which is almost "a replica" of the mechanism of the old gold standard will be revealed. It will also be seen that a highly complicated technique would have to be evolved with regard to the management of the internal credit structure in order that a substantial measure of flexibility may be imparted to the whole system.

Suppose India is a deficit country, that is, a net purchaser and "buys" foreign exchange from the Fund. The buyer is the Government through the Reserve Bank of India. The official account with the Reserve Bank will be debited and the Fund's account with the Reserve Bank will be credited. So far the position of the Banking Department of the Reserve Bank will have remained unchanged. Now the Reserve Bank of India sells

¹ *Annual Report of the Executive Directors, I.M.F.*, September 1946.

the foreign currency so acquired to the scheduled banks, which in turn sell it to their customers. Payment will be made by the scheduled banks by a debit to the item "Bankers' Deposits" and a credit to "Government Deposits". As a result of this process, the scheduled banks' reserve deposits with the Central Bank and their demand deposits will be reduced by an equal amount, as would happen in the case of an outflow of gold under the gold standard. As the scheduled banks are under obligation to hold only a fractional reserve against their demand liabilities, their reserve position will deteriorate. In case the scheduled banks do not enjoy excess reserves and the Reserve Bank, possibly losing gold at the same time, does not take steps to improve their cash position, there will inevitably be a contractionist pressure on the Indian economy with deflationary effects upon national income, prices and imports. In order that the ratio of cash to deposits may be restored and the deflationary process averted, the authorities would have to purchase bills and securities in the open market. But this would result in the member banks being forced to sacrifice earning assets in the attempt to replenish their reserves, while the funds with which to make these purchases of securities and bills would have to be created by advances to the official account by the Reserve Bank. For, official funds would have been used for the original purchase of the exchange and the proceeds of the subsequent re-sale to the scheduled banks would have merely restored them. The increase in the Fund's account with the Reserve Bank may be turned to India's advantage in that it could be used for the purchase of official obligations which would have the effect of re-transferring funds from the balance standing to the credit of the I. M. F. to that standing to the government's credit. The government would thereby be spared the necessity

of borrowing from the Reserve Bank. If India is a surplus country, the reverse would be true. Foreign exchange received in payment for net exports would be sold to the Reserve Bank of India. In the process the reserve deposits of the scheduled banks with the Reserve Bank would be increased to the same extent as the increase in their demand deposits as would occur with an inflow of gold under the gold standard. The reserve position of the commercial banks would thus be improved and the basis for credit expanded. To counteract this potential, reverse action will be called for on the part of the authorities who will have to sell bills or securities in the open market until the excess reserve is mopped up.¹

The monetary mechanism provided here is closely reminiscent of the gold standard mechanism. Prof. Williams had contended that both the Keynes and White plans were "essentially gold standard plans,"—merely "variants of the gold standard system." The same observations may be made in regard to the Bretton Woods plan. As in the original plans, movements of gold are unnecessary but their function is preserved and performed by currency transfers in the Fund. Bank reserves are affected by these currency transfers precisely in the same manner as they would be by gold movements in a gold standard; and the same monetary and price effects may be produced as under a gold standard.² Any member which becomes a surplus country is in the position of a gold receiving country while a deficit country is in that of a gold losing country. But it will be misleading to suggest that the parallels between the operations of the Fund and the working of the

¹ H. E. Evitt, *Exchange and Trade Control in Theory and Practice*, pp. 92-93. Also G. N. Halm, *International Monetary Co-operation*, pp. 76-77.

² J. H. Williams, *Post-war Monetary Plans*, pp. 8-9.

gold mechanism go very far. Under the gold standard adjustment, the debtor country might be forced to pass through a painful process of deflation while the creditor country may develop inflationary tendencies. It is true that, as under the gold standard, there is no compelling reason to assume that there would be an expansion of credit. But in sharp contrast to the gold standard, the deflationary consequences of transactions with the Fund will not be accepted by any member country. One will search in vain the provisions of the Fund, or of the original plans or the Joint Statement for any hint or suggestion that deficit countries are expected to pursue deflationary policies according to the rules of the gold standard game. Indeed it is almost certain that the planners of the Fund intended that this part of the gold mechanism should be obliterated or at least allowed to operate not automatically, but under strict control.¹ It has nowhere been contemplated that the process of adjustment and the achievement of international equilibrium shall come through internal deflation, depression and unemployment.² It is in this respect that the fundamental difference with the gold standard is to be observed.

The Bretton Woods plan is definitely not a return to the old gold standard nor is it a subtler version of the gold standard. Gold indeed plays an important rôle. First, it is the international unit of account since the currencies of the member countries are expressed in terms of gold. Secondly, it maintains the liquidity of the Fund's resources, since the Fund tends to replace its local currency resources by gold whenever feasible. Member

¹ G. N. Halm, *Monetary Theory*. p. 285.

² A. Hansen, *op. cit.*, p. 81.

countries also have to pay a part of their subscription in gold; under certain conditions they have to sell gold to the Fund for local currencies. It is also true that gold is "securely entrenched" in the plan. But all this does not mean a re-introduction of the gold standard and gold mechanism. In the case of the old gold standard the internal structure of prices and incomes would have to conform to a rigid exchange rate; and internal stability had to be sacrificed on the altar of a rigid parity of the exchanges. The Bretton Woods plan has provided for orderly adjustments of the exchange rates through international collaboration so as to correct a fundamental disequilibrium without forcing member countries to pass through a painful deflationary process.

It is this feature of flexible adjustment that sharply distinguishes the I. M. F. plan from the traditional gold standard. Critics have facetiously dubbed the plan as one of "how to go swimming without getting wet." As Mr. Hansen has observed, it could be better labelled as a plan of "how to swim without drowning." Nobody can claim greater authority to pronounce on what is or what is not the essence and meaning of a gold standard than Lord Keynes. In the course of a well-known speech in the House of Lords, he observed that the plan was "the exact opposite of the gold standard." The standard, as he understood it, meant a system under which the external value of a national currency was rigidly tied to a fixed quantity of gold which could only honourably be broken under *force majeure*; and it involved a financial policy which compelled the internal value of the domestic currency to conform to this external value as fixed in-terms of gold. In the Bretton Woods plan gold is no doubt a common denominator in terms of which the par values of the different member currencies are expressed. But "the use of gold merely as a convenient

common denominator by means of which relative values of national currencies—these being free to change—are expressed from time to time” is not a return to gold. Gold is not indeed demonetised. That would not have been palatable to the British Commonwealth and Russia as principal producers and to the U. S. A. as the main holders. But gold has been dethroned as the fixed standard of value for it has been expressly provided that it is the Fund's duty to alter the gold value of a currency, if it could be shown that this would be serviceable to equilibrium.¹

A few observations may be made in this connection with regard to the changes in the value of a member's currency. The Fund is committed to promote exchange stability, to avoid competitive exchange depreciation and to provide a machinery for orderly adjustment of exchange rates when such is needed for correcting a fundamental disequilibrium. There is of necessity a conflict between stability of exchange rates and stability of the internal credit situation. The real problem is how to reconcile a reasonable stability of foreign exchange rates with the maintenance of a high level of economic activity in each individual country. Faced by the conflicting claims of freedom and flexibility on the one hand and the desirability of fixed exchanges on the other, the I. M. F. has provided that each member after consulting the Fund, can change the par value of its currency by as much as 10% by unilateral action, the Fund not being entitled to object in such a case. Beyond this 10% the approval of the Fund is no doubt required but a very important direction is given to the Fund in making its decision. “The Fund shall approve

¹ Speech of Lord Keynes in the House of Lords, May 23, 1944. *Parliamentary Reports (Lords)*, Vol. 131, pp. 845-846.

a requested change in the par value of a member's currency if it is essential to correct a fundamental disequilibrium. In particular the Fund shall not reject a requested change necessary to restore equilibrium because of domestic, social or political policies of a country applying for a change.¹ Here is a marked change of emphasis in the I. M. F. proposals as compared to the original Keynes and White plans. Although the Keynes plan was based on flexible rather than fixed exchange rates, yet the flexibility was managed and limited. A member might depreciate its exchange by 5% if its debit balance exceeded a quarter of its quota on the average of at least two years; otherwise all changes had to be approved of by the Board.² In the White plan all changes without any exception required the sanction of the Board and by not less than a four-fifths majority.³

The Fund is intended to fill an important role in helping orderly exchange adjustments and in avoiding competitive exchange depreciation.⁴ In considering a requested change the Fund shall take into consideration "the extreme uncertainties prevailing at the time the parities of the member currencies are initially agreed upon." In many cases it will be found that the initial par values that have been established will be incompatible with the maintenance of a balanced international payment position at a high level of domestic economic activity. At the exchange rates communicated to the Fund there are undoubtedly wide disparities in wages and price-levels among many countries. But as the whole world to-day is in the grip of a terrible shortage of goods, foreign

¹ Art. IV, Sec. 5 (f).

² Proposals for an International Clearing Union. Art. II. Sec. 8 (a).

³ U.S. Proposals for a United and Associated Nations Stabilization Fund Art. IV, Sec. 2.

exchange values may be maintained by some countries at a level which may not prove to be a handicap to their export trade at the present moment but which may prove to be so later on, when there is a general revival of production and the current shortage has been removed. Such countries without a lowering of the exchange rate may find it difficult to sell sufficient exports to meet the cost of their essential imports. In such cases the Fund should recognise the unusual circumstances under which the initial par values were determined and assist in making the necessary exchange adjustments. Again, under the stress of the war, the currency systems of many countries have completely broken down and it would be one of the most important tasks of the Fund to rehabilitate such weak currencies and integrate them in the world structure of exchange rates. The period of consultation may be extended for such countries and the determination of their par values may be postponed until the internal monetary and economic situation becomes more stable.¹

Criticisms of the I. M. F. :

Prof. Williams has criticised the I. M. F. from several points of view and has entertained grave doubts as to its usefulness and effectiveness. The transitional problems and those arising out of relief, reconstruction and settlement of international indebtedness have been particularly urgent at the present moment and require careful handling. But these problems have been specifically excluded from the purview of the Fund. Member countries have been permitted to retain exchange control during the transition period. Some of them e.g., Great Britain and India have already taken steps

¹ First Report of the Executive Directors of the Fund. *Federal Reserve Bulletin*, October 1946, pp. 1129-30.

to continue the war-time controls in the post-war period. The Fund has been envisaged as a long-term agency of monetary regulation. But what will the Fund do during the transition period, asks Prof. Williams?¹ In sharp contrast the Keynes plan had specifically included relief expenditure and the White plan had made provisions for a gradual liquidation of abnormal war balances. When these purposes are not envisaged and specific transitional needs of exchange are to be met outside the Fund, it is doubtful if there will be a *general* need for foreign exchange resources. But the need for such exchange will be, not general, but specific.¹ Many countries have emerged out of the war with substantial reserves of international money and there will be hardly any need for the Fund to supplement the existing resources. The resources of gold and foreign exchange of the neutral countries like Sweden, Switzerland, Portugal and Spain are expected to be much larger than ever before. The gold reserves of the occupied countries like those of Belgium, France and the Netherlands will be fairly large. The gold and dollar holdings of the Latin—American countries increased from 900 million dollars in 1939 to about 3½ billion dollars in 1944. Here as in many other countries (such as India and Egypt) the increased holdings of foreign exchange have been the result mainly of Allied war expenditure. Indeed in many instances exchange control has to be imposed not that there is a paucity of foreign exchange resources but because the available supplies are much too large in relation to the prevailing shortage of goods to be bought elsewhere. In such circumstances the provision of loans and gifts for purposes other than those envisaged under the Fund is more urgently

¹ See Arts. by Prof. Williams in the *Foreign Affairs* and his *Post-war Monetary Plans and Other Essays*.

necessary at the present moment than supplies of foreign exchange. Prof. Williams has contended that the supply of foreign exchange would be superfluous and dangerous for many countries while for others it would be much too inadequate. But in reply it may be pointed out that there will be still many countries whose reserves of international money would be meagre and many others whose external resources would be quite moderate. As Prof. Bernstein has pointed out, of the 44 countries represented at Bretton Woods, 5 had virtually no gold or dollars, 13 had gold or dollars equal to 2% or less of their exports in 1938 and 21 equal to 50% or less. A moderate drop in the value of these countries' exports not being improbable in any one year, it is clear they will not be able to export gold to meet a possible deficit in their balance of payments without affecting their reserve position.¹ Such countries would undoubtedly need a line of credit to fall back upon. That there is a genuine need for the Fund is indisputable. It may not be necessary for many to use the resources of the Fund currently but the time may come when it will be necessary to do so. A limited and controlled line of credit which perhaps need never be drawn upon but which nevertheless is always there as ultimate protection and insurance is the true conception of the Fund. Prof. Williams is under a misapprehension when he argues that foreign exchange will be obtained through the Fund by member countries almost as a matter of automatic right. That is not a correct view of the functions to be fulfilled by the Fund. The Fund is under no obligation to deal out its credits right and left indiscriminately to all applicants without considering the econo-

¹ Art. by E. M. Bernstein in the *American Economic Review*, December, 1944.

mic conditions and developments in each country. It has already been stressed that no member has an unrestricted right to draw upon its line of credit. The Fund may suspend any member from further use of its facilities or set a limit to such use whenever it is of the opinion that the facilities offered by the Fund are being misused. There is the scale of charges mounting higher and higher as the amount and duration of the "loan" increase. It will also not be possible for member countries with large resources of foreign exchange outside the Fund to abuse its line credit. A member country must keep a reasonable balance between the use of its own resources and the use made of the Fund's resources. It is provided that a member country must use its own resources, as a minimum, at a rate equal to its use of the Fund. If its own monetary resources increase, it will be recalled, the member country must reduce its past borrowings at the Fund at a rate equal to the increase in its outside monetary holdings. As regards the charge of inadequacy we can do no better than quote the remark which Lord Keynes made with regard to the quotas of the "Joint Statement." They were "an iron ration to tide over temporary emergencies of one kind or another." While this ration was obviously not large enough to live upon during the reconstruction period, "it is large enough for the purpose for which it is intended."¹

Another line of criticism made by Prof. Williams deserves careful consideration. It is that the Fund will be constantly threatened with a scarcity of dollars and at the same time be constantly in danger of being glutted with currencies of countries with inadequate resources of international money, which would be likely to make the greatest use of the Fund's

¹ Speech in the House of Lords, May 23, 1944.

facilities. The main trouble, observes Prof. Williams, in the scheme of the Fund lies in the disparity between the possible demand for dollars and the available supply of dollars in the Fund. It presents a serious dilemma for which the articles of the I. M. F. have provided no solution: Prof. Williams is afraid that a dollar crisis and dollar hoarding round the world may arise as modern counterparts of the breakdown of the gold standard that occurred whenever there were one-way large and continuous gold movements.¹ Under the mechanics of the Fund, the dollar resources of the Fund would be drawn upon by members paying for American exports but these would not be replaced when payments would be made by the U. S. A. for her imports. Such payments are made with dollars and not by purchasing foreign currencies. These dollars will not find their way to the Fund but will go to the foreign exporters to the U.S.A. to form dollar balances to their credit outside the Fund in the foreign exchange market. In other words, there would be a "seepage" of dollars from out of the Fund into private hands and it will be no simple problem to recapture these seeping dollars. The present practice is for foreign exporters to invoice in dollars. A sudden change-over to invoicing in local currency is not practicable. Moreover that would be worrying American importers who are, under the prevailing practice, spared the trouble of securing foreign currency. But it is precisely such a situation that the repurchase and rationing provisions are intended to meet. There are, further, the provisions limiting the borrowing of members during a year. As it has been stressed before, the Fund must not be regarded as the main source of supply of foreign exchange. It does not supplant but merely supplement the regular private

¹ J. H. Williams, *Post-war Monetary Plans and Other Essays*, p. xxx.

exchange operations. The line of credit with the Fund will usually be considered as a source to be tapped in the last resort and will be carefully conserved by the member countries.

That the demand for exchange in transactions with the Fund will be solely confined to U.S. dollars is an unwarranted assumption. Other currencies, notably Canadian dollars, may also be in demand. Even if the bulk of the demand were limited to American dollars, the United States, by granting large international loans and maintaining a high level of economic activity at home, might make the supply of dollars currently available outside the Fund quite sufficient. As a recent writer has well observed, disequilibrium in the United States balance of payments would have to continue on a large and persistent scale, before there would be a shortage of dollars in the Fund.¹ Moreover it is not the Fund which would create this problem of dollar shortage. The problem, if any, will be there with or without the Fund. The present ratio between maximum demand for dollars in the Fund and the supply thereof amounts to 2 : 1. The risk assumed is not unreasonable and is closely analogous to that run by every commercial bank with demand liabilities far in excess of cash resources. Finally, the heavens will not fall if central banks' reserve ratios were to touch the legal limit. In the same manner the heavens will not crack if the Fund's dollar resources were to get exhausted. As Mr. Hansen has observed, these criteria are signposts but not ends in themselves.²

In technique the I. M. F. follows closely the pattern of the American proposals for a Stabilisation Fund. The pat-

¹ A. Hansen, *America's Role in World Economy*, p. 70.

² *Ibid.*, p. 72-73.

tern was deliberately chosen in preference to that of the Keynesian Clearing Union. It has been claimed by British experts that the two "technical set-ups" essentially serve the same purpose. The theoretical elegance of the Keynes plan was undisputable. But it would have been a novel and unfamiliar experiment in the sphere of international exchange. The world was not at all prepared for this "radical innovation". To it the mechanism of the Fund, as we have it now, appeared to be closer to something which was already familiar and was readily accepted.¹ Thus we have in the Fund a set-up akin to a supranational Exchange Equalisation Account but subject to all the inherent limitations of such accounts.² There is, however, one difference of outstanding importance. While the British Exchange Equalisation Account was operated under a mysterious veil of secrecy, the Executive Directors of the Fund will prepare and publish annual reports relating to its working.

Few will question the desirability of a universal multilateral stable exchange currency system as embodied in the Fund. But the question is whether the system possesses sufficient elasticities to enable it to work under conditions where the gold standard had failed disastrously.³ Elasticity and the largest possible measure of individual freedom constitute the keynote of the Fund. Indeed the Fund has even been criticised as being much too elastic and free. If the elasticities in the scheme are great enough to save it in the event of an economic blizzard of the type of the Great Depression, it should certainly be welcomed. If at the same time it affords an

¹ Art. by E. V. Morgan in the *Economica*, August 1944.

² *The Statist*, April 29, 1944.

³ *The Economist*, August 12, 1944.

opportunity for building a free and co-operative system of world trade, it should be doubly welcomed.

(Admittedly the Fund has its own limitations. Without co-operation from its members, it can accomplish very little.) A monetary organisation, however ably it may be designed, is no substitute for wise policies in the national and international spheres. The Fund has immense possibilities but, as the *Economist* has observed, in a world whose basic ingredients are increasing production, full employment, freer and expanding world trade, absence of chronic budget deficits and above all international peace and amity.¹ But it will be misleading to suggest that the Fund would be able by itself to solve the current economic problems of the world. It was never designed for that purpose nor does it possess the necessary power or resources to do so. The scope of the Fund has been frankly recognised by its Executive Directors to be limited. Its function is "to aid members in maintaining arrangements that promote the balanced expansion of international trade and investment and in this way contribute to the maintenance of high levels of employment and real income."

¹ *The Economist*, November 9, 1946, pp. 757-58.

CHAPTER II

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

While the Fund has been ushered into the world in the full blaze of publicity, "heralded" by a fanfare in the form of a "Joint Statement" by Experts, the sister organization, the Bank, has demurely made her debut almost unnoticed. Besides the spectacular development of the elder sister, the younger one has grown up in relative neglect and obscurity. She did not certainly excite the acute controversies which raged over the virtues of the elder sister, but there are many who believe that her virtues are vastly superior. Prof. Williams, for instance, doubts the usefulness of the Fund in the transition period but is very optimistic about what may be accomplished through the Bank. Indeed he would like to explore the possibilities of extending its functions, so as to include some part of what is designed for the Fund. While the experts insisted that the Fund could not work without the Bank, Prof. Williams has argued that there will hardly be any need for the Fund, if the Bank's work is well done and is supplemented.¹ According to him the peculiar problems of the transition period which involve relief, reconstruction and liquidation of abnormal war-time balances call for loans and gifts : they point to the need for a Bank rather than an Exchange Stabilization Fund.²

Although it is true that either of the two institutions can

¹ J. H. Williams, *Post-war Monetary Plans* ("After Bretton Woods"), pp. xxxvi—xxxvii.

² Art. in the *American Economic Review* by J. H. Williams, March, 1944, p. 372.

be a success without the other, yet they are closely related in that the motif running through both is contribution to world stability and development. The objective of the two institutions is the same but the mechanism through which they will operate is different. While the Fund will function through short-term financial operations, the Bank will be principally concerned with improving the quality and increasing the volume of long-term investment. The Fund will help member countries to bridge short-period disequilibrium in their balances of payments ; the Bank is supposed to promote the long-range balance of payments equilibrium through the development of their productive resources. It will be recalled that reconstruction and relief have been excluded from the purview of the Fund. Reconstruction and development have been stated to be of the very essence of the Bank.

A tremendous end-of-war problem facing most countries is the unprecedented need for foreign capital. The economies of a large number of belligerent countries have been shattered almost beyond repair. Factories and mines, public utilities, works, buildings and railroads have been severely damaged and even totally destroyed ; vast areas have been devastated ; entire industries have been wiped out. Enormous capital is necessary to repair, restore and reconstruct the war-torn economies. Capital will also be needed for the reconversion of industries producing war-goods to peace-time production. Again, there are many countries which are economically under-developed and large investment will be needed to encourage the development of their productive facilities and resources. Countries whose productive capacities have been seriously damaged by the war will find that their industries are unable to supply the capital good while their people are unable to provide the savings required for investment and

reconstruction. They will inevitably have to depend upon the flow of foreign capital. Non-industrial and backward countries will also need foreign capital to obtain the funds for purchasing machinery, equipment and other capital goods for development. Even those countries which can provide capital from domestic sources will not be absolutely independent of foreign funds. These will be needed to supplement the domestic resources. Never before in any known period of history was there a greater and more desperate need for long-term credit for productive purposes. Never was there a more urgent need for a machinery which would encourage private capital to flow into foreign countries for productive investment by sharing the risks of private investors and participating with them in large ventures.¹

Experience during the inter-war period amply demonstrated the sad plight of borrowing countries anxious for reconstruction and development. Capital was either unavailable or was available at extraordinarily high premiums or in the dangerous form of short-term capital. The flow of such "risk capital" was fraught with disastrous consequences for the borrower as well as the lender. What was lent for the avowed purpose of short-term investment was often employed for long-term purposes. It was also frequently invested without any reference to the marginal efficiency of the projects concerned. It was essential that a part at least of foreign borrowings should have been invested in projects calculated to enhance the productivity of export industries and thereby build up an export surplus out of which the debt could be repaid. The flow of this uncontrolled foreign

¹ Foreword by Mr. H. Morgenthau Jr. to the Preliminary Draft Outline of a Proposal for a Bank for Reconstruction and Development.

lending of the 1920's brought in its train deflation, depreciation and waves of default in the 1930's. Lending countries were equally at fault. They had not only lent without any reference to the economics of the situation but had also stipulated for rigid servicing and repayment obligations. Indeed the defaults were often due to the inelasticity of the debt instrument.

The purposes of the International Bank, as set out in the Articles of Agreement, are to assist in the reconstruction and development of territories of member countries by facilitating the investment of capital for productive purposes including the restoration of economies disrupted or destroyed by the war, the reconversion of productive facilities to peace-time needs, and the encouragement of the development of productive resources in relatively undeveloped countries. All these objectives have to be attained by the investment of capital for productive purposes. Domestic capital being inadequate or unavailable, the Bank will promote private foreign investment by means of guarantees and participations in loans and other investments made by private investors. When private capital will not be available on reasonable terms, the Bank will supplement private investment by direct loans for productive purposes out of its own capital, funds raised by it and other resources. Finally, the Bank will promote the long-range balanced growth of international trade and the maintenance of equilibrium in the balances of payments by encouraging long-term international investment, thereby assisting in raising productivity, the standard of living and conditions of labour in member countries.¹

The authorised capital of the Bank has been fixed at

¹ Art. I.

10,000 million dollars. This capital stock can be increased if three-fourths of the total voting power agree. The subscription agreed at Bretton Woods amounted to 9,100 million dollars. The subscription assigned to each individual member corresponds in general to its quota in the Fund. 20% of the Bank's capital is subject to call of which 2% has to be paid in gold or dollars and 18% in the member's own currency. The balance of 80% will remain uncalled except in cases of default to provide security for the guaranteeing function of the Bank. In payment of the 2% of its capital subscription, the Bank received until the time of the first annual report \$143,786,883.70 in gold and U.S. dollars. Two additional calls were made for the payment of 3% and 5% of the subscriptions in local currencies. As a result of these various payments the Bank had capital resources amounting to nearly \$242 million of which \$14 million were in gold, \$9.4 million being held in the Federal Reserve Bank of New York and \$4.6 million being held in the Bank of England.¹

The evident intention of the Agreement is that the loans granted by the Bank should be of long duration. There are several clauses which indicate a period longer than ten years. The general trend of the discussion was also to the effect that the normal life of a loan would be considered to be longer than 10 years. The Bank will make loans only to member governments or to borrowers who have been guaranteed by their governments, central banks and similar agencies.¹ The total amount outstanding of direct loans, guarantees and participations in loans has been limited to 100% of its

¹ First Annual Report to the Board of Governors of the International Bank for Reconstruction and Development, September 20, 1946.

¹ Art. III, Sec. 2.

unimpaired subscribed capital, reserves and surplus.¹ Thus the total liabilities that may be incurred can not exceed the capital resources of the Bank and thus the total maximum risk which a member incurs in joining the Bank is limited by its subscribed capital. The Bank can make no loan out of its holdings of local currency without the approval of the member whose currency is involved. The Bank also can not sell its securities nor can guarantee loans in the market of any member without his consent.²

The Bank is in effect limited to two types of loans (1) reconstruction loans and (2) development loans. Credits for the restoration and reconstruction of the economies of member countries which have "suffered great devastation from enemy occupation or hostilities" will be liberally granted and will enjoy priority No. 1 among the operations of the Bank. It has, however, never been the intention that the Bank should tie up all its capital in loans for reconstruction purposes. On the contrary the Articles of Agreement have provided that the Bank's resources and facilities should be used for equitable consideration to developmental and reconstruction projects alike.

The Bank will not make "tied" loans. Art. III Sec. 5 (a) has provided that the Bank shall impose no conditions requiring that the proceeds of a loan shall be spent in the territories of a particular member. It is a sound principle of international investment, generally unheeded in the inter-war period, that international loans should not lead to bilateralism. Like the Fund, the Bank is based on the principle of multilateralism; and no political or economic strings will be attached to the loans which the Bank makes, guarantees or

¹ Art. III, Sec. 3.

² Art. IV, Secs. 1 and 2.

participates in. There will be no bar to money borrowed in one country being spent in another country nor will the collection of debts be subject to exchange control. The competitive influence of the Bank may, further, deter private investors from imposing conditions on the borrowers which would be contrary to the principle of multilateralism. The borrowers themselves will not be able to co-erce creditors into bilateral arrangements by using payment difficulties via exchange control.¹

It is difficult to see, however, how the provisions in this section apply to loans made out of the Bank's own capital when the Bank can lend only the local currencies of members. Such loans under Art. IV. Sec. 2 (a) are inconvertible into other currencies without the consent of the members.² In another respect the Bank appears to fall short of a strict application of the principle of multilaterality. As a rule it will not provide the borrowing member with the member's own local currency. In other words, domestic loans will not be arranged by the Bank.³ The Bank, however, in exceptional circumstances, when local currency required for the purpose of the loan can not be raised by the borrower on reasonable terms, may provide the borrowers as part of the loan with an appropriate amount of local currency. In this connection it may be observed that the Bank's lending policies should be guided entirely by economic considerations irrespective of the politics of the member countries. But attempts may be made to prevent lending to nations not that their political policies

¹ G. N. Halm, *International Monetary Co-operation*, p. 189.

² Art. by Arthur Smithies in the *American Economic Review*, December, 1944.

³ Art. IV, Sec. 3(a). Also G. N. Halm, *International Monetary Co-operation*, p. 190.

are objectionable but because the economic consequences of these policies are believed to militate against the speedy recovery of the world.

Presumably, at any rate in the short run, the lending capacity of the Bank will be fully taxed in accomplishing barely the most essential tasks of world reconstruction. In such circumstances, as a group of recent writers has suggested, a cardinal short-run criterion will be to extend reconstruction credit only (1) when it is essential (2) where it provides a maximum stimulus to production and (3) when the borrower has no other reasonable alternate source of credit facilities. Reconstruction of war damage has to be conceived in the broad sense of restoring a nation's gross national product to the level prevailing in a pre-war normal period rather than in the narrow sense of merely rebuilding the specific productive facilities which the war had damaged or destroyed. Thus conceived, the task of the Bank would be to help member countries to utilize their available resources of power, fuel, raw materials, idle man power, existing technical and transport facilities, so that the pre-war level of output may be restored on the basis of a sound stable economy and on a basis involving the minimum of outside financial help.¹

In sharp contrast to reconstruction credits, development loans are intended to create new productive facilities in areas where they were previously non-existent or to expand existing facilities. The directive given to the Bank in this connection in Art. I (i) leads one to believe that special consideration will be given to the developmental needs of the under-

¹ Art. by N. Weyl and M. Wasserman in the *American Economic Review*, March, 1947, p. 95.

developed areas of the world,—Asia, Africa and Latin America. By far the bulk of the reconstruction credits will flow into countries having highly complex and integrated economies. The development credits will be concentrated in member countries with backward and loosely-knit economies in proportion to the extent of their economic backwardness and the existence of unused or idle human and material capacity. After the war damage has been repaired in Europe and the transition from a war-time to a peace-time economy has been accomplished, the Bank will primarily serve, as it has been well observed, as an instrument for “the global dissemination of the industrial revolution.” Its main task will then be to extend industrialisation and develop modern transportation and scientific agriculture in those parts of the world which do not possess them now.

As the chief source of international investment in the post-war world, the Bank is being envisaged as the regulator of internationally financed industrial development.¹ It will have to decide the most economic location for the industries it has been called upon to finance as well as estimate the pace at which an over-all expansion of various industries may be achieved without causing instability and default. In this capacity it will have the long-range function of guiding and stimulating the development of world resources and industries.

By carefully using its power to make developmental loans, the Bank can play a useful part in mitigating the impact of international cyclical fluctuations and thereby contribute to the creation of more stable employment conditions in the world. When private investment tends to decline, the Bank may increase its own activities and produce a beneficial

¹ *American Economic Review*, March, 1947, p. 98.

counter-cycle effect.¹ A certain portion of the Bank's lending capacity may indeed be set apart for financing works suitable for such purpose. As some recent writers have pointed out, the technical requirements to be fulfilled by such works are that they can be quickened or retarded at will ; they should require periods of many years for their completion ; they should involve a high proportion of capital goods imports in relation to the total programme and entail large simultaneous local currency investment by the borrowing members.² Combined hydro-electric developments, railroad construction and modernisation programmes belong to this category.

The procedure for handling loan applications, as agreed upon by the Executive Directors, will consist of three stages. The President, after preliminary talks with the intending borrower, will put up his application before the Executive Directors. If the Executive Directors determine that the Bank should continue the negotiations, they will authorise the President to appoint an *ad hoc* Loan Committee to examine the proposition. Each Loan Committee will include not only some members of the technical staff of the Bank but also an expert selected by the member in whose country the project to be financed is located. The Loan Committee will study the proposition and submit a written report with its recommendations. The final decision will be made by the Executive Directors.³

Long-term loans for reconstruction of war-devastated areas are inevitably risky. But it has been rightly contended that they would at least be more soundly conceived when

¹ G. N. Halm, *International Monetary Co-operation*. p. 188.

² *American Economic Review*, March 1947.

³ First Annual Report of the Executive Directors of the International Bank, *Federal Reserve Bulletin*, October 1946, p. 1136.

made through the Bank than otherwise. It has been definitely provided that the loans made by the Bank should not be general purpose loans but only for the purpose of specific projects. These projects, as we have just seen, will be carefully investigated by an expert committee. Another important feature is that the Bank will make its loans at rates of interest lower than what would obtain in the private investment market. Countries torn by an anxiety to reconstruct will be inclined to borrow at any cost and even at the risk of default. That would inevitably saddle their economies with an enormous burden in the future. This strain will be relieved to a considerable extent by the Bank which will increase the capacity of the borrowers to repay their obligations. The Bank will also provide sufficient flexibility in respect to debt repayment so as to minimise the possibility of defaults.

Criticisms of the Bank :

It has been argued that the Bank will supplant private foreign lending altogether. But nothing can be further from the intention of those who designed the Bank. The Agreement has definitely provided that the object of the Bank will be to supplement and promote private foreign investment rather than compete with it. The Bank will make a loan only when it is satisfied that the borrower will not be able to obtain one on terms considered reasonable by the Bank for him. Investors may be deprived of some opportunities for making highly speculative profits. But a new type of international security bearing the hall mark of approval of an international institution would be provided to institutional investors seeking a safe and more attractive avenue of investment, alternative to domestic securities.

Even if the Bank is able to meet the legitimate demands for foreign credit for some time to come, there would still remain for the private foreign holder a close and profitable preserve. The private investor may flourish in the markets for the securities of non-member countries and of private enterprises in member countries lacking the usual guarantee and in the entire sphere of equity financing. Again, the Bank itself may decline to participate in issues backed by first class collateral so that they may be available for the private investor.

Another line of criticism directed against the Bank is that it has a definite pro-debtor and anti-creditor bias, as the Fund was accused of entertaining a pro-creditor and anti-debtor bias. The resources of lenders, it has been contended, are placed at the disposal of an institution which is largely controlled by borrowers.

In the beginning the borrowing countries may have a majority of Executive Directors but not necessarily a majority of total voting power. The point is not that the lenders will be prejudicially affected but that the Bank offers advantages both to lenders and borrowers. As Lord Keynes pointed out, many countries which were not in a position to lend would be enabled by the Bank to undertake some of the responsibility involved in promoting the common object of world prosperity through increasing the flow of foreign investment. In the dangerous and difficult post-war years, the lenders' risks are likely to be greatly magnified and may be almost incalculable. The risk premium determined on commercial principles will be beyond the capacity of many borrowers to meet and may breed dangers of ultimate repudiation. "Without some supporting

guarantee, loans which are greatly in the interest of the world and indeed essential for recovery, it may prove impossible to float." As the *Economist* observed, the risk will be taken by all, but the actual cash will be provided by those best fitted to furnish it.¹

A third group of critics asks, how can such a bank be international, except in a limited or formal sense in a world containing many debtors and one creditor ? The U.S.A. cannot escape the creditor's risks. Loans guaranteed by the debtor against default do not make them any better. "Who is to guarantee the guarantor ?" But it is most unlikely that not only the actual borrowers but all the non-creditor member countries will be simultaneously involved in a completely illiquid position in ordinary circumstances. Such a contingency is conceivable only in the event of a world wide credit crisis of unprecedented dimensions. But that is exactly what the Bank has been designed to avert.

The *Economist* argued that the Bank, like the Fund, could really work in a world under conditions whose fulfilment is improbable, though not impossible altogether. An ideal bank in an ideal world, as it has been well observed, would indeed be quite different from the present institution. But such an ideal world would not require any bank at all. The planners of the Bank have been quite conscious of its limitations and they have not designed it to attain the impossible.

¹ *The Economist*, September 9, 1944.

CHAPTER III

THE RESERVE BANK AND THE I. M. F.

By a Viceregal Ordinance promulgated on December 24, 1945, India had ratified the Bretton Woods Agreement and had become an original member of the International Monetary Fund and the International Bank for Reconstruction and Development. About a year later the Indian Legislature, having considered the third Report of the Committee on Bretton Woods Agreement, approved of India's continued membership of the Fund and the Bank. India was called upon to pay to the Fund her subscription of \$400 million by March 1, 1947. Under the rules of the Fund, gold of the value of 10% of her gold and dollar holdings was transferred to the Fund. Of the rupee subscription a certain amount was credited to the Funds' account and the balance was paid in the form of non-negotiable and non-interest bearing promissory notes convertible into rupees on demand by crediting the par value to the account of the Fund. This membership of the Fund has attached to it a string of obligations which raise several important issues relating to India's monetary system and call for consequential amendments to the Reserve Bank of India Act, 1934.

It will be recalled that one of the main objectives of the I. M. F. is the establishment of multilateralism in international trade, or as Art I (iv) has put it, assistance in "the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the

growth of foreign trade." The laws and practices of the Reserve Bank have to be suitably amended so that they may be given the necessary multilateral orientation.

One of the most important questions that arises in this connection is whether the multilateral obligations imposed upon the Reserve Bank by virtue of India's membership of the Fund would allow it to confine its holdings of foreign exchange to sterling only. In other words, would not the present statutory holding of a sterling reserve be considered discriminatory? The Reserve Bank would have to maintain multilaterality of exchange transactions between our currency and those of the member countries. It is clear that multilaterality could not be maintained under the provisions of Secs. 33, 17, 40 and 41 of the Reserve Bank of India Act.

Under Sec. 33 which relates to the assets of the Issue Department, not less than 40% of the total assets should consist of gold coin, gold bullion or sterling securities, the amount of gold coin and bullion being at least forty crores of rupees in value. The balance of the assets may be held in rupee coin, rupee securities and approved bills of exchange. Although the rules of the Fund are not known to have laid down a maximum limit to the amount of a particular foreign currency that may be held as the legal cover for the note issue of a member country, it is clear that multilateral exchange transactions can only be facilitated by including an assortment of important foreign currencies in the monetary reserves. Sec. 33 will have therefore, to be amended so that the Reserve Bank may hold, besides sterling, some hard currencies in its assets. The Reserve Bank will then be enabled to observe the multilateral obligations by its willingness to buy and sell foreign currencies within the limits prescribed by the I. M.F.

The question of amending Secs. 40 and 41 also arises in this connection. Under these two sections the Reserve Bank is under obligation to buy and sell sterling at a rate not higher than 1s. 6/3/16d. and not lower than 1s. 5/49/64d. for a rupee respectively. Under Art. IV Sec. 3 of the I.M.F. the maximum and minimum rates for exchange transactions between the currencies of the members shall not differ in the case of spot transactions by more than 1% and by a margin to be determined by the Fund in the case of other transactions. The purposes of multilaterality would be served if these two sections were suitably amended so that the Reserve Bank might be authorised to buy and sell gold or foreign exchange freely within the limits prescribed by the Fund for the settlement of international transactions.

Sec. 17 of the Reserve Bank of India Act, 1934 also requires to be amended. Among the businesses specified in this Section which the Bank may transact, the following are included.¹

- (a) Purchase from and sale to scheduled banks of sterling,
- (b) Purchase, sale, and rediscount of sterling bills,
- (c) Maintaining of sterling balances,
- (d) Purchase and sale of sterling securities of H.M.G.

These are provisions which may be regarded as discriminatory in favour of sterling, and as such call for suitable amendment.

Art. V Sec. 7 of the Fund Agreement has also an important bearing on the existing Sec. 33 of the Reserve Bank of India Act. The article relates to the well known and much discussed "repurchase" provisions. It has already been

¹ Sec. 17 (3) (a) (b) (c) and (7).

pointed out that it is of particular significance to countries which conduct a large proportion of their foreign trade in terms of foreign currencies like the sterling or dollar and maintain their foreign exchange balances in these currencies. At the end of each financial year India will have to examine the changes in its monetary reserves in relation to the use of the Fund's resources and make the prescribed adjustments. The effect of these provisions will be to cause definite annual variations in the structure of the Reserve Bank's foreign exchange holdings in the Issue Department, although they do not call for the maintenance of a definite ratio of the foreign exchange reserve to the total note Issue.¹ It is clear, therefore, that India's membership of the Fund will bring about a variety of changes in her monetary system which will affect not only the size of her monetary reserve but also the manner in which its composition will be made up.

Some of the amendments to the Reserve Bank of India Act may have to be effected immediately. The amendments to Secs. 40 and 41 belong to this category. They have become necessary along with the declaration of the par value of the Indian rupee.

The Government have fully appreciated the position and the Finance Member (Mr. Liaquat Ali Khan) moved the *Reserve Bank of India (Second Amendment) Bill* for the Assembly's consideration on April 8, 1947 which was subsequently passed. The external value of the rupee had hitherto been regulated by Secs. 40 and 41 of the Reserve Bank Act. These sections, it will be recalled, prescribed that the Bank should sell to any person on demand sterling for immediate

¹ *The Eastern Economist*, October 11, 1946, p. 585 and January 17, 1947, p. 5.

delivery to London at a rate not below 1s. 5/49/64d. and the Bank should buy such sterling from any person on demand at a rate not higher than 1s. 6/3/16d., the amounts of sterling to be bought and sold not being less than £10,000. Under the Articles of Agreement of the I.M.F. member countries are under obligation to express the par values of their currencies in terms of gold; and exchange rates will be determined by the rates which such par values bear to each other. As a result of India's membership of the Fund and the fixing of par values thereunder, sterling is no longer the sole determinant of the external value of the rupee. The continuance of a direct statutory link with sterling through Sections 40 and 41 became both unnecessary and inappropriate and hence the Sections 40 and 41 have been repealed and replaced by a new section.¹ Under the amendments the Bank will be under obligation to sell or buy from any authorised person, on demand, foreign exchange at rates determined by the Central Government from time to time, having regard to its obligations to the I.M.F., it being provided that the amount of foreign exchange to be bought or sold shall in each case be of a value not less than Rs. 2 lakhs.² The margin between the maximum buying and the minimum selling rate for sterling has been narrowed down as compared with the older rates—the new rates being respectively 1s. 6/9/64d. and 1s. 5/55/64d. This change has been called for by the provision in Art. IV Sec. 3 of the I.M.F. under which the maximum and minimum rates for exchange transactions between member countries' currencies shall not differ in the case of spot exchange transactions by more than one per cent. The Reserve Bank's new minimum selling and maximum buying rates will

¹ *Reserve Bank of India Bulletin*, May, 1947, p. 295.

² Sec. 40. *Reserve Bank of India (Second Amendment) Act, 1947.*

enable authorised dealers to carry transactions with the public at rates less than one per cent. below and one per cent. above the parity;¹ and the terms of the above Article will thereby be satisfied.

This is the much discussed amendment which has been hailed as terminating the historic link of the rupee with the sterling. The Finance Member has characterised it "as a most important measure because it signalises the emergence of the rupee as an independent currency." The effect of these provisions would be to delink the rupee from sterling and its coming on to what may be described as an "international standard."² The rupee will henceforth be linked to currencies of all countries which are members of the Fund and will no longer need to follow sterling as it would have done under the rigid link, if a substantial variation of the currency was decided upon by the British monetary authorities.

Indian students of monetary matters have long felt that the sterling link carried the idea of political subordination into the monetary field; and this de-linking has been welcomed as the dawn of a new era of financial autonomy in place of the old financial imperialism. The adoption of an exchange standard has been considered here as elsewhere as being hurtful to national pride and prestige.³ But as a matter of fact the dependence of the exchange standard country upon the country whose currency is chosen as the standard is not one-sided. The latter is as much dependent upon the former. The standard country can not have full sovereignty over its

¹ *Reserve Bank of India Bulletin*, June, 1947, p. 358.

² *Legislative Assembly Debates*, April 8, 1947, Vol. IV, No. 10 p. 3088.

³ J. M. Keynes, *A Treatise on Money*, Vol. I, p. 19.

monetary policy but has to act in agreement with the various members of the system. A refusal to observe this rule of the game will bring about the disintegration of the entire system.¹ But whatever that may be, it must be observed that the de-linking has not been accomplished with the primary objective of giving an independent status to the rupee but solely because of the obligations which India's membership of the I.M.F. entails.

These sections have also been frequently under a withering fire of criticism as providing the mechanism by which sterling balances have been accumulated against the issue of rupees and as the means by which inflation has reached its present proportions in the country. As Mr. Manu Subedar observed in the Legislative Assembly, "this country has been bled white by these provisions in the Reserve Bank Act.... bled white for purposes which we have not approved and in a manner which has hurt every section and every class of the people in the country and which has resulted in an enormous amount of value being removed from this country in the form of sterling balances."² There is no doubt a considerable amount of truth in the contention that the abuse of the two sections generated the enormous inflationary forces in the country and their repeal must be welcomed. But here again, what led the Government to consider repeal was not that, but India's adherence to the I.M.F. It should also be pointed out in this connection that the immediate practical effects of the de-linking will be hardly of any significance. In practice the Reserve Bank will continue as before to deal in sterling till the foreign exchange position of India gets

¹ Heilperin, *International Monetary Economics*, p. 207.

² *Legislative Assembly Debates*, Vol. IV, No. 10, p. 3089.

clearer with the settlement of the sterling balances.¹ For a long time the Reserve Bank will be unable to give effect to multilateral convertibility, for India has already decided to adopt exchange control measures under the I.M.F. provisions relating to the transition period.²

India's Foreign Exchange Regulation Act, 1947 follows closely the lines of the corresponding British legislation. As the Finance Member observed while referring the Bill to the Select Committee, the Government decided to continue exercising control over foreign exchange transactions not only in the interests of India but to ensure that the best use was made of our exchange resources in implementing our programme for industrialisation and development. Apart from this, India's membership of the Fund has imposed upon her definite obligations to promote exchange stability and orderly exchange transactions.³ The decision of the Government to continue exchange control is not inconsistent with India's obligations to the Fund. While the Fund is anxious to promote exchange stability and eliminate all those restrictions which hamper the growth of foreign trade, it has expressly recognised the right of member countries to maintain control over capital transactions of their residents. Indeed there are certain circumstances in which member countries may be called upon by the Fund to impose exchange restrictions. Such restrictions will particularly apply to movements of capital.⁴ We have a painful memory of the disturbances caused to international exchange by the speculative movements of short-term capital in the inter-war period. Such movements have to be

¹ The Hon. Finance Member, *Legislative Assembly Debates*, April 8, 1947.

² *The Eastern Economist*, April 11, 1947, p. 665.

³ *Legislative Assembly Debates*, November 12, 1946, p. 139.

⁴ Art. VI, (3) ; Art. VII (3) ; Art. XIV (2).

stopped in the future. The Fund has laid a general emphasis upon a liberal administration of exchange control, yet it envisages these restrictions upon movements of capital which caused so much damage to the exchange stability of the leading countries in the past. Thus exchange control, though apparently incompatible with the objectives of the Fund, has been considered to be indispensable in these circumstances.

Although the Indian and British measures have a great deal in common,—the former being a counterpart of the latter,—and are based on similar principles, yet they differ in one or two important respects. While no time limit was set in the case of the British measure, the Select Committee in the case of the Indian legislation proposed a duration clause of five years in the first instance, empowering the Government to extend that period by a further period not exceeding three years.¹

There is another contrast. The British Exchange Control measure has granted exemption to transactions within the sterling area by including a schedule of “scheduled territories” within which exchange control would not apply. The Indian Act omits any such schedule. This does not, however, mean that India will operate exchange control vis-a-vis other countries in the sterling area.

The effect of this section has no doubt been to terminate the freedom of transfer between India and other sterling area countries in the absence of a general permission from the Reserve Bank as existed in the previous Defence of India Rule 92-A, but power has been given to the Reserve Bank to

¹ Clause 1 (4). “It shall remain in force for five years only but the Central Government may by notification in the official Gazette direct that it shall remain in force for a further period not exceeding three years.”

exclude specified currencies and the Reserve Bank has already issued notifications giving general permission for payments to or for the credit of or on behalf of persons resident in countries comprising the so-called sterling area.¹ The decision to omit a schedule of "scheduled territories" was made, as the Finance Member pointed out, because in view of India's new status, it was not desirable to include in the Act a schedule of territories to which exchange control restrictions would not apply, as this might give the impression that India wished to continue permanently the system of pooling her foreign exchange which was a feature of the sterling area arrangement. As in the case of the statutory sterling link, the expression "sterling area" has contained for many of us a faint hint of "financial imperialism," and carried the idea of political subordination to the monetary sphere. The Finance Member has been congratulated by the *Economist* upon the change of nomenclature as showing "a masterly and perhaps unique tact." This measure like the sterling link has undoubtedly enabled India to express her financial sovereignty. But it must be observed that the operation of the sterling area was not harmful to the members alone. It also involved certain inconveniences to London, the reserve centre. While England could not "go off sterling," the members of the sterling area could obtain competitive trade advantages at her expense by pegging their currencies to the pound at an excessively low level.²

Sec. 17 of the Reserve Bank of India Act has also been amended by the Reserve Bank of India (Second Amendment) Act, already referred to. The Reserve Bank of India will now

¹ *Report on Currency and Finance*, Reserve Bank of India, 1946-47, pp. 61-62.

² *International Currency Experience* (League of Nations), 1944, p. 111.

be able to buy and sell securities issued by the Government of any country outside India which is a member of the I.M.F.¹

As a result of the measures discussed above, the rupee has now become an independent currency taking its place in its own right among the currencies of the nations which are members of the I.M.F. The country has also been enabled to attain financial independence. But a number of other amendments including that of Sec. 33 of the Reserve Bank Act will also be necessary. We have been assured by Sir Cyril Jones, Finance Secretary, that the Government will bring forward all the necessary amendments in course of time.² When the negotiations for the settlement of the sterling balances are completed, it would be possible to have a complete and clearer picture.

¹ Clause 3. *The Reserve Bank of India (Second Amendment Act)*, 1947.

² *The Statesman*, April 12, 1947, (Council of State Proceedings).

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